CORPORATE GOVERNANCE AND CORPORATE PERFORMANCE: IMPLICATIONS FOR TRANSITION ECONOMIES

A Doctoral Thesis Presented by

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DECLARATION

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ABSTRACT

This study examines corporate governance modes in different international business systems: the Anglo-Saxon, the Communitarian, and the Asian/emerging business systems. The review of the literature covers the link between corporate governance and the agency problem on the basis that the latter is concerned with the conflicting interests between corporate managers and its financiers. In this respect, the literature has come up with mechanisms that can mitigate the negative effects of the agency problem such as incentive contracts.

The study also addresses the conventional practices of corporate governance as equivalent to practices of corporate finance. In this respect, debt financing and equity financing are discussed as the two main financial tools that shape the financial phase of corporate governance.

The management discretion, upon which financing mechanism(s) is (are) to be relatively relied upon, is inherent the certain institutional infrastructure that permits certain financing mechanism to relatively dominate the other(s). In this concern, the study discusses the political-legal perspectives of corporate governance.

Considering that different international business systems result in different institutional structures and orientations, the financing mechanisms available in each system create certain economic institutions such as the stock markets, banks, ...etc. In this regard, the study discuses, from international business perspectives, the basic corporate governance mechanisms: the stock

market governance, the banks governance and the role of the board of directors in corporate governance.

The study extends the current domain of corporate governance to address non-financial issues drawn from the literature of social-business studies in international business context. These issues are corporate orientation towards its stakeholders interests and corporate identity as determinants to the corporate relative competitive position in the marketplace. In addition, from a transitional markets point of view, the study examines what information can be disclosed to company's stakeholders for monitoring its performance, thus providing an evidence that helps corporate stakeholders to certify the company's business affairs.

INTRODUCTION

The emerging markets, in general, and the transitional emerging markets, in particular, are to examine the most convenient and adaptable path of development. The conventional modes of corporate governance structures and mechanisms - as merely mechanisms of corporate finance - may not be viable to emerging markets as long as their institutional infrastructure is not well adaptable to accept this mode of governance. This necessitates to extend the scope of the current practices of corporate governance to explore additional viable alternatives that can be adaptable to the unique institutional infrastructure of the emerging and the transitional markets. These alternatives are to be examined in the developed countries first before recommending any of them as a viable one(s) to the case of emerging markets.

Accordingly, this study extends the current domain of corporate governance as equivalent to corporate finance and financial economics to address related issues drawn from the literature of the social foundation of business studies. These issues are corporate orientations toward its stakeholders interests and the influential role of corporate identity as determinants to corporate relative competitive position in the marketplace. Finally, this necessitates to explore the approach that can be used to release relevant information to corporate stakeholders. The approach used in this study is the **Z**-Score model as one of the most common approaches used for monitoring corporate performance.

Corporate orientation towards its stakeholders' interests, including its shareholders' interests, is important to the emerging markets as long as their unique institutional infrastructure is not well adaptable to accept the shareholders-driven corporate governance mode.

Concerning the issue of 'Corporate Identity,' the inherent intangibility of product and service quality, especially in the services and knowledge-based industries, leads to problems in measurement costs. This necessitates a firm to depend on its stakeholders as a convenient indices that determine corporate identity in the marketplace.

Concerning the **Z**-score model as a monitoring tool, a firm in a transitional emerging market should determine what information is to be disclosed to its stakeholders so as to enhance its identity, then its relative competitive advantage in the marketplace.

OBJECTIVES OF THE STUDY

As this study explores corporate governance issues in emerging markets, it is to emphasis on some of the distinct aspects that can widen the current domain of corporate governance practices to include issues that can be relevant to emerging markets. Therefore, the general outline of the objectives of this study is to provide some insights drawn from developed and matured markets to both corporate managers and policy makers in emerging markets. Specifically, the objectives of this study can be stated as follows.

1. Examine the current scope and practices of corporate governance on the basis of the underlying institutional path-dependence embedded in running business enterprises in different business systems.
2. Examine the non-financial aspects of corporate governance. This objective is necessary for emerging markets, in general, and for transitional

emerging markets, in particular, on the basis that the financial aspects of corporate governance have already been examined extensively in the developed countries that are characterised by their mature markets. The study, therefore, provides an extended governance structures that can be adaptable to the emerging and transitional markets which are characterised by their immature markets and institutions.

3. This study presents the extended and adaptable corporate governance structures in an applied form which means that they are to be tested empirically so that they can be of practical use.

METHODOLOGY OF THE STUDY

The methodology of this study consists of two main sections. The first section discusses the types of research design used in the study. The second section discusses the research methods used in the study. From a methodological point of view, the classification of study types was developed with reference to research design issues while research methods are concerned primarily with the researcher's tasks, the work that will have to be done, the techniques that are to be used and problems that may be encountered (McBurney, 1998; Hakim, 1997). That is, the research methods focus on the implementation stage, the procedures and tasks for translating the initial idea into a plan of action, while the research design focuses on the design stage, so study types are distinguished with reference to their purpose and intellectual strategy rather than the methods or techniques used.

Strategy of the Research Types: An Overview

1. Theoretical Research and Policy Research

This study outline can be considered a theoretical research as much as it is a policy research. The former provides knowledge for understanding and the latter provides knowledge for action (Majchrzak, 1984; Hakim, 1997). Accordingly, for better understanding of the different corporate governance structures in the context of international business systems, a theoretical research approach is adopted in the first part of the thesis. As the theoretical research is concerned primarily with causal processes and explanation, the various aspects of international corporate governance modes are discussed on theoretical basis. These aspects are based primarily on the relevant previous research findings that highlight the general scope and magnitude of corporate governance practices in the international context.

Part two follows the approach of policy research as it provides knowledge for action. As the theoretical research is selective in its nature (Smelser, 1980), this requires the policy research to encompass a more diverse variety of research including theoretical research. In this sense, part two provides an empirical study that contributes to the theoretical and empirical foundations of international corporate governance modes. Therefore, the policy approach results in an actionable variables that extend the current practices of corporate governance to include new perspectives: those that are referred to as the 'competitiveness phase of corporate governance.' The resulted actionable variables meet the diversity in interests of the corporate governance constituencies, hence provide new perspectives that are to be considered catalysts for change in practice. In this sense, chapters 3 and 4 address respondents as role-holders who are responsible for making corporate decisions.

As the policy research is considered a multi-method or multi-level study (Majchrzak, 1984), part two of this study is a multi-dimensional where it investigates empirically three issues (chapters 3, 4, and 5) that broaden the scope of the current practices of corporate governance. Specifically, chapters 3 and 4 test two issues on the corporate level, while chapter 5 tests an issue on an international level. In this sense, the multi-dimension approach enhances the probability of generalisation. As long as the policy research tends to focus on testing whether a particular antecedent is necessary or sufficient cause of a known behaviour or result(s), it requires that the dependent variable is identified and the antecedents, or causes, are assessed (Miller, 1977). Therefore, the way the research methods are conducted in those three chapters is based mainly on the premises that the dependent factor - e.g., corporate competitiveness - is, and should be, the ultimate aim of corporate decisions, thus the results are to provide robust associations that address the underlying factors that contribute to corporate competitiveness. In this sense, the policy research approach tends to be more useful to policy interests as well as being of greater disciplinary interest: the benefits are not mutually exclusive.

2. Qualitative and Quantitative Research

A qualitative research approach is adopted in this study. In theory, qualitative research is concerned with individuals' own accounts of their attitudes, motivations and behaviour. The qualitative research is used for exploratory studies leading to more structured or quantitative studies (Light and Pillemer, 1984). Moreover, the qualitative research can be extremely valuable for identifying patterns of associations between the underlying factors, subjects and issues of the study (Blaxter, 1979; Van Maanen, 1979; Walker, 1985).

A qualitative research is basically developed in chapter 3 to address the issue of the corporate stakeholders and its link to corporate performance and corporate competitiveness. Specifically, qualitative research in conjunction with quantitative research are carried out to link banks' orientation - as active corporate monitors - towards the stakeholders theory to banks' performance. The essence of this link is that the more the corporate monitor is active and effectual, the higher its influence on corporate orientation, then on corporate decisions.

A qualitative research approach is undertaken in chapter 4 as well. This chapter discusses the role of intentional information released by a firm in determining its identity, therefore, its competitive position in the market.

The quantitative research is carried out in chapter 5 through undertaking Multivariate Data Analysis to build a **Z**-score model: a statistical model that is used to monitor corporate performance (Altman, 1971; Deakin, 1972; Taffler, 1984). Nevertheless, Chapter 5 combines both of the quantitative and qualitative research approaches since number of the underlying qualitative issues and/or variables have not been tested quantitatively before.

Types of Research Design used in the Study

The study of corporate governance in international context requires careful examination of the most convenient research types that are to be undertaken. In general, the international dimension of the study needs the researcher to consider the differences between and among the various international systems under consideration. Therefore, no one type of research study is inherently inferior or superior to others as each does a particular job (Hakim, 1997). In this sense, the study types undertaken in this study are as follows.

1. Literature Reviews

Part one of this study outlines a review of the literature on corporate governance. It is carried out as a part of ground-clearing and preparatory work for the empirical part of the study. As long as the literature of corporate governance itself is a multi-dimensional - as it is related to various constituencies, hence addresses various issues - the research review is based on an assessment of the relevant empirical research that highlights the aspects of corporate governance modes in an international context.

The multi-dimensionality requires the research review to be multi-disciplinary. That is, a review of the relevant research done in the literature of finance, management, law, and economics is considered. In so doing, all of the relevant journals, text books and reading books are considered. In general, when reviewing a literature, it is recommended to cover both of the contemporary and historical situation at the same time (Cooper, 1984).

Accordingly, the focus is on the historical and current practices of corporate governance in an international perspectives.

Specifically, the current practices of corporate governance are discussed in chapters 1 and 2. Chapter 1 focuses on the current state of corporate governance including agency problem, the financial structures of corporate governance, i.e., the interaction between corporate managers and financiers. In addition, chapter 1 highlights a brief outline of the political-legal framework of the current state of corporate governance. Chapter 2 focuses on the mechanisms through which corporate governance practices are undertaken. The latter includes the role of the main financial institutions (the stock markets and banks) in addition to the managerial role in corporate governance, that is, the managers' influences on corporate financial and investment decisions.

The literature review is undertaken as a policy-oriented research review which summarises the current and historical knowledge on the various phases of corporate governance to show, then draw out, the relevant policy implications that are in the interests of, and practical to, various interest groups on the micro-level, i.e., the corporate managers, and the macro-level, i.e., the policy makers. An important aspect of the literature review is addressing issues which have re-emerged in the policy agenda and in the literature as well.

2. Secondary Analysis

The researcher has carried out a secondary analysis to build a **Z**-score model for the Egyptian Textile Sector. The model is used in practise to monitor corporate performance (Altman, 1971; Deakin, 1972; Taffler, 1984).

The detailed statistical methodology used for building the model is described in chapter 5. As the secondary analysis involves the use of multiple datasets to provide an overall assessment of findings on a topic (Stewart, 1984; Hakim, 1982, 1997), the Z-score model is built through combining various measures of corporate performance. These measures, therefore, are considered a multi-source dataset that includes those that are commonly used for measuring corporate financial performance, those used for measuring corporate strategic performance, basic measures of corporate governance, and those used for measuring corporate international transitional performance.

Considering Egypt as an emerging country in transition, the Z-score model developed in this study is to be used to monitor company's transitional performance. In this sense, the ultimate aim is to make sure whether a company's transitional performance is, or is not, showing to its stakeholders those aspects of competitiveness. This is one of the core dimensions of part two which is the empirical part of the study.

3. Analysis of Administrative Records

Administrative records are collections of documents containing mainly factual information compiled in a variety of ways and used by organisations to record the development and implementation of decisions and activities that are central to their functions (Hakim, 1983, 1997; McBurney, 1998). This type of research is employed in chapter 5 to build the Z-score model of the Egyptian Textile Sector. The data was collected from many sources. Firstly, from companies' annual reports. Secondly, from companies' performance reports held by many authorities in Egypt. These authorities are the Ministry of

Industry, the Public Sector Authority, Information and Decision Support Center (IDSC), and the annual reports of the Textile Industry held by the three Holding Companies to which the thirty one textile companies (the population of this study) report to. In this case, the administrative records are used in their own right for research on the policy process itself and in evaluation research. In this sense, the Z-score model is to provide a basis for evaluating the corporate performance in a transitional country like Egypt.

Theoretically, the analysis of administrative records may be similar to secondary analysis. That is, any research uses information from administrative records constitutes secondary analysis given that the primary use of the records was for administrative purposes. Nevertheless, this similarity does not exist in chapter 5 of this study considering that the data used to build the Z-score model is not recorded specifically for research purposes rather it is recorded as a by-product of the organisation's day to day activities. This issue is to be emphasised because economic studies routinely use data collected by others, thus raise questions concerning the quality and limitations of the data, and frequently fail to distinguish between data from records and research data, treating both as if they were interchangeably valid and appropriate for any research analysis (Sayer, 1984; Griliches, 1985).

4. Ad Hoc Sample Survey

The development of sampling theory and techniques in the early part of the twentieth century led to the sample survey becoming one of the most widely used methods of data collection in social research (Hakim, 1997). In general, The ad hoc survey is used increasingly for highly focused studies of particular social groups of narrowly defined issues. Procedures for identifying and sampling minority groups become an integral part of survey design. The term 'minority group' is used to refer to any target population for a survey that is relatively rare because it has very specific characteristics or experiences (Hakim, 1997). Sample surveys allow associations between factors to be mapped and measured. The type of the ad hoc sample survey used in the study is the 'Sample Survey on Role and Relationships.' It is discussed as follows.

Sample Survey on Role and Relationships

This type of survey seeks information about the individual relationships and interactions or activities with other people. Here, the informant is considered as a role-holder who can supply information about social units, events and processes. This type of research is employed particularly in chapter 3 where two roles were examined in the banking industry. The first role is the one of Corporate Loans Managers as representatives of, and responsible for, banks' loans and borrowing policy and their relationships with the borrowers (firms). The second role is the one of the Finance Directors as representatives of, and responsible for, the bank's investment policy including investing part of the bank's capital in the stock market which is considered a significant part of a bank's business.

The essence of these roles and relationships is that the Corporate Loans Managers have a close relationship with the banks' borrowers (firms). Furthermore, the former's roles and responsibilities in the banking business encourage them to be active monitors of their clients performance. The same is true for the Finance Directors where their responsibilities encourage them to act in the best interests of the shareholders.

As a strategy of the research types, an important advantage of the ad hoc sample survey is that it offers a multi-purpose research design with many advantages for both policy research and theoretical research. That is, sample survey provides transparency or accountability, the fact that the methods and procedures are visible and accessible to other parties be they professional colleagues, clients, or the public audience for the study. Regarding the orientation towards the interests of corporate stakeholders, the transparency of sample survey is very important aspect when surveying the respondents' orientations. Therefore, the results of the survey can provide a basis for further theoretical development and practical considerations for policy research.

It is worth to mention that although the ad hoc surveys are designed and carried out on a 'one off' basis, they can, nevertheless, be repeated at irregular intervals of time, thus offering some of the advantages of regular surveys for measuring changes over time. Accordingly, as the issue of stakeholders theory is still debatable on different international business systems, the ad hoc surveys can be replicated in other business systems or other countries, thus provide a very good basis for international comparative analysis.

The ad hoc survey data of banks' orientation towards the importance of corporate stakeholders was supplemented by the addition of information from administrative records that include measures of banks' performance. The aim is to measure the association between the banks' orientation and their performance.

Multi-Disciplinary Research Design

The multi-disciplinary research is becoming an increasingly and acknowledgeable strand of research in the applied science, in general, and in the social science as well. The multi-disciplinary-oriented research in social sciences has contributed significantly to much understanding of the individuals' behaviour and organisations - as social societies - on the ground that the individuals and organisations are run, and constrained, by a nexus of economic, political, legal, and social rules and/or norms. This is the underlying practical contribution of the multi-disciplinary research on social sciences that benefit the society.

The researcher extends the conventional domain of corporate governance, as merely an equivalent to corporate finance, to explore additional issues that stem from socio-economics and from the link between economics, organisation and management. Specifically, part one reviews the literature on corporate governance form financial, legal, managerial, and economic perspectives. Chapter 3 discusses the issue of corporate stakeholders which is linked to the literature of management and interrelationship between and among economics, organisations and management. Chapter 4 discusses the issue of corporate identity which is rooted in the literature of socio-economics. Finally, chapter 5 discusses monitoring corporate transitional performance and the underlying governance structures in transitional emerging markets which is closely linked to the international institutional differences that determine international corporate governance modes.

As the core of this study is multi-disciplinary, it necessitates multi-disciplinary research design. Accordingly, as it is mentioned above, the researcher has followed more than one type of research study: the research reviews, secondary analysis, qualitative in conjunction with quantitative analysis, analysis of administrative records, and ad hoc sample survey.

Research Methods used in the Study

1. Research Methods used in Chapter 3

Sampling

The issue of corporate stakeholders versus shareholders orientation is debatable in the literature of corporate finance, corporate governance, business organisation, and corporate law. Furthermore, the debate is continued at the level of the different business systems. This may add complexity regarding what are the most practical individuals and/or institutions that are to be targeted to assess the relative magnitude of corporate stakeholders.

Fortunately, this complexity can be mitigated by considering the fact that banks are considered a very viable financial institutions. That is, banks are a common factor, e.g., a viable source of finance, in different international business systems. Banks provide loans to corporations which necessitates the bank loans managers to play an active role in monitoring their clients performance. In addition, quite apart from the differences between international business systems, banks are entitled to invest part of their capital in the stock market and, at the same time, are entitled to provide an advice to their clients who are willing to invest in the stock market.

Consequently, banks have good expertise in both monitoring corporate performance and investing in the stock market. This close relationship between banks and their corporate clients permits the researcher to explore whether banks are able to support corporate stakeholders orientations. The population of the study is the British banks and foreign banks located in the UK. Within banks, as the major population of the study, two groups were chosen: Corporate Loans Managers in the commercial banks and Finance Directors in the investment banks. The first group is assumed to represent the banks' role as corporate creditors. In this sense, the Corporate Loans Managers are assumed to be a reliable source of information about the borrowing companies. The second group is assumed to represent the banks' role as an advisers and dealers in corporate stocks trading. In this sense, the Finance Directors are assumed to be a reliable source of information about the shareholders, therefore the stock market, trends of corporate securities trading. In this regard, both of those two groups should be most knowledgeable about the full range of measures adopted in the literature of this study (Boyd *et al.*, 1993). Therefore, the type of sampling used in this study is the 'purposive sample.' The purposive sample is selected nonrandomly but for the particular reasons mentioned earlier. In addition, the purposive sample has an advantage over the other types of sampling that it can be considered to constitute a population (McBurney, 1998), which is true in this study. The population of this study, therefore, consists of 86 major commercial and investment banks:

the major British and foreign banks operating in the UK. A list of the banks' names and addresses is provided in the POLK World Banking Profiles (1996).

Questionnaire

The issue of the relative importance of corporate stakeholders and their effects on corporate performance is examined by a questionnaire which is one of the most widely methods used to survey people's opinions and attitudes toward various issues and events (McBurney, 1998).

The objectives of the questionnaire used in the study: It is noted earlier that the conventional corporate governance structures and practices in the Anglo-Saxon business systems - as merely practices of corporate finance - stem from the principal role the stock markets play to provide companies the needed capital. It follows that the principal investors are shareholders. This is why the problems of 'economic short-termism' centres around the shareholders' short-term expectations and, consequently, the management's short-term objectives.

The main objective of the questionnaire, Therefore, is to avoid the problems of short-termism and to extend the corporate governance time horizon to address long-term objectives. In so doing, the researcher examines the effects of corporate stakeholders' orientations, including corporate shareholders' orientations, on corporate performance. The literature review of stakeholder issues on corporate governance (Freeman and Reed, 1983; Freeman and Evan, 1990; Ziegel, 1993; Karmel, 1993), corporate stakeholders (Freeman, 1984; Cornell and Shapiro, 1987; Barton *et al.*, 1989; Preston and Sapienza, 1990; Savage *et al.*, 1991; Hill and Jones, 1992; Clarkson and Deck, 1993; Jones, 1995; Donaldson and Preston, 1995; Greenley and Foxall, 1997;

Rowley, 1997; Mitchell *et al.*, 1997), and corporate social responsibility (Preston *et al.*, 1978; Dierkes, 1980; Rey, 1980; Cochran and Wood, 1984; Aupperle *et al.*, 1985; McGuire *et al.*, 1988; Clarkson, 1991, 1995) provided the basis for developing the questionnaire used in this study. The questionnaire contained 20 variables related to various aspects of those three fields of research.

The questionnaire design: The questionnaire design encompasses only closed-ended questions. There are two main reason behind this orientation. Firstly, as it is cited in research methods textbooks (Fowler, 1988; Hellevik, 1984; Neuman, 1991; McBurney, 1998), the open ended questions are harder to code. Secondly, as mentioned above, the data was collected from two different persons in two different, and very important, positions in the banking industry. In this case, if the open-ended question were included, the questionnaire would have been long enough for each of them to spare time answering the open-ended questions. This would have reduced the response rate. Nevertheless, the closed-ended questions include sufficient options that cover the wide range of the aspects included in the literature of corporate governance in conjunction with corporate stakeholders and corporate social responsibility. The format of the closed-ended questions are mutually exclusive questions and Likert scale. Finally, the questions were developed in a format that permits easy coding and using of statistical packages (Gaito, 1980), specially SPSS and STATGRAPHICS Plus 3.1.

The method of administering the questionnaire: The questionnaire was mailed to the respondents: the Corporate Loans Managers in the commercial banks and the Finance Directors in the investment banks working for the major British and foreign banks located in the UK (POLK, 1996). The questionnaire was accompanied with a personal letter explains the nature of the research and highlights the importance of banks as a viable source of financing, then contributing significantly to economic development. The questionnaire was sent to each bank's Corporate Loans Manager and Finance Director by mail. Of the 86 major commercial and investment banks a total of 48 banks responded representing a response rate of 55.8 per cent [Appendix (3-2)]. To test for non-respondent bias, the results from the later respondents were compared to those of the early respondents. (Filion, 1976; Armstrong and Overton, 1977). The differences between respondents and non-respondents were not statistically significant.

Statistical Analysis

The statistical tools used in chapter 3 are as follows (Daniel and Terrell, 1995; Newbold, 1995; Berenson and Levine, 1996).

A) Simple Factorial ANOVA Analysis is carried out to test the sample consistency. That is, to test whether there is a significant difference between the two respondents (the Corporate Loans Mangers and the Finance Directors), it requires to test whether their answers are relatively drawn from the same work background.

B) 'Chi-square test of goodness of fit' (χ^2) is carried out to test data normality. This test determines whether the sample data are compatible with the hypothesis that they are drawn from a population that follows some specified functional form, the uniform distribution or the normal distribution. The purpose of this test is to determine whether parametric or non-parametric statistical methods are to be used.

C) Analysis of variance 'ANOVA' is carried out to test hypotheses about the equality of two or more than population means. The type of the ANOVA that is used is the *one-way analysis of variance*. The term one-way refers to the fact that the classification of each survey unit (and consequently the measurement obtained) is done according to one criterion, i.e., the group to which they belong to. In the case of this research population study, the Corporate Loans Manager belongs to only one group in each bank, so does the Finance Director. From the point of view of the assumptions underlying ANOVA models, the researcher is using the *random-effect model* on the basis that the respondents who returned the questionnaire back represent a sample of the population. Here, the *random-effect model* is to use the sample results to make an inference about the entire population.

D) Principal Component Factor Analysis (varimax rotation) is carried out to test the discriminant validity of the variables included in the study (Podsakoff, and Organ, 1986). The object of the PCA analysis is to take a number of variables and find combinations of these to produce indices, i.e., factors that are uncorrelated . The lack of correlation is a useful property because it means that the factors are measuring different dimensions in the data (Manly, 1998; Hair *et al.*, 1995). Therefore, PCA is used to reduce the dimensionality of the data set by appropriate transformation of the original data. The original data variables are projected into new axes such that the new variables, orthogonal to each other and thus uncorrelated, are linear combinations of the old (Taffler, 1981). The decision to include a variable in a factor was based on factor loadings greater than 0.50 and all factors whose eigenvalue was greater than one were retained in the factor solution (Tabachnick and Fidell, 1989; Hair *et al.*, 1995).

E) Data reliability is tested by carrying out a Reliability Analysis (*Alpha*) to determine the extent of the consistency and reliability of the data.

F) Stepwise Regression Analysis between banks performance measures and their stakeholding orientation.

2. Research Methods used in Chapter 4

Sampling

The researcher is examining the issue of corporate identity in the banking industry. As corporate identity is intangible on the basis that it is related to the quality and content of a company's products and services, this necessitates to look at an industry where knowledge is the primary assets. This is true in the banking industry where banks' identity is determined by the external intermediaries' assessment of the quality and content of the banks' products and services which, in turn, depend upon the bankers' experience and banking knowledge. Therefore, the central issue in examining banks identity is related to what information a bank releases which can help external intermediaries to do good assessment to the quality of the banks services, thus can help in determining the bank's competitive advantage in the market place.

On that basis, the researcher has targeted the advertisements made by banks in the Economist magazine during the year 1995. As the Economist magazine is issued on a weekly basis, banks advertisements are considered a good source of the content and extent of information released about banks. The type of sampling is random selection as long as most of the international banks advertise regularly on this magazine, thus each bank advertisement has the same probability to show up on each weekly issue.

Content Analysis

A content analysis is carried out to measure banks' drivers of identity and their association with banks' performance. The sample survey is basically carried out through analysing the content of the information mentioned in banks' advertisements in the Economist magazine during the year 1995. Considering intangibility is the central characteristics of banks, and most other financial services industries, banks' advertisements provide a reliable source of information about banks' indices of identity. In this case, the content of banks' advertisements includes an indices (Jervis, 1985; Choi and Lee, 1996) that can be used as drivers of banks' identity.

The researcher used the two types of content analysis, manifest content and latent content (McBurney, 1998). The former is based on counting the frequency of the indices of identity, and the latter is based on the assessment, rather than only counting, of the magnitude of the indices of identity mentioned in each advertisement. The manifest content provides the advantage of easy coding the content, thus turns out to be more reliable. But the frequency itself may not indicate the extent of emphasis if it is not mentioned in the proper context. Therefore, one has to examine the magnitude of the frequency by further undertaking latent content analysis in order to increase the reliability of the content analysis. A Reliability Analysis for the collected data is undertaken. More details about this test are mentioned below.

Statistical Analysis

The statistical tools used in chapter 4 are as follows (Daniel and Terrell, 1995; Newbold, 1995; Berenson and Levine, 1996).

A) 'Chi-square test of goodness of fit' (χ^2) is carried out to test data normality.

B) Data reliability is tested by carrying out a Reliability Analysis (*Alpha*) to determine the consistency of the data.

C) Stepwise Regression Analysis is carried out to determine which of the independent variables (banks indices of identity) account(s) more for variations in the dependent variable (performance measures). As this type of the linear regression analysis is very useful for undertaking pure description and extrapolations for examining new issues and relationships (Hocking, 1976), it is, therefore, convenient to use for exploring the importance of corporate identity as a determinant of the corporate relative position both in the its local market and in international context.

D) *TUKEY'S HSD* (Honestly Significant Difference) test is used to carry out pairwise comparisons between the three basic business systems: the Anglo-Saxon, the Communitarian, and the Asian/emerging business systems. The purpose of this test is to explore the extent to which banks in two business systems converge in terms of their orientation towards the emphasis on indices of identity. In this sense, the pairwise comparisons are more helpful than the comparisons among the three systems at a time because the latter do not show specifically which business system is more oriented towards each of the indices of identity.

3. Research Methods used in Chapter 5

Sampling

The issue of monitoring the transitional corporate performance in Egypt as an emerging country is examined by building a **Z**-score model for monitoring the transitional performance in the Textile Sector in Egypt. The Textile Sector comprises thirty one companies of which seven companies were privatised since the privatisation of the Egyptian public sector has formally been undertaken by late 1991.

Archival Data

The data used in this study cover the period from 1992 to 1997. The data was collected from many sources. Firstly, from companies' annual reports and financial accounts. Secondly, from companies' performance reports held by many authorities in Egypt. These authorities are the Ministry of Industry, The Public Sector Authority, Information and Decision Support Center (IDSC), and the annual reports of the Textile Industry held by the three Holding Companies to which the thirty one textile companies (the population of this study) report to.

The data needed to build the **Z**-score model is basically to be in the form of ratios with different time and scale dimensions. The data available from the records of the Egyptian Textile Sector were neither in the required form nor classified to be compatible with those ratios required to build the **Z**-score model. Therefore, the researcher has undertaken numerous of calculations to put the available data in the required forms. Nevertheless, all of the data is formal data which means that it complies with the Egyptian regulations and legislation. In addition, in terms of consistency and completeness, the data is very relevant to the nature and the use of the model in practise, e.g., monitoring corporate performance in a transitional country.

Statistical Analysis

The three main statistical tools used in chapter 5 are as follows.

1. 'Chi-square test of goodness of fit' (χ^2) is carried out to test data normality.
2. Principal Component Analysis (PCA-varimax rotated) is carried out to test the discriminant validity of the variables included in the study (Podsakoff, and Organ, 1986).
3. Discriminant analysis, which is the most common technique used to develop **Z**-score models, is carried out. The problem that is addressed with discriminant analysis is how well it is possible to separate two or more groups of observations (i.e., individuals, companies, ...etc.), given measurements for these observations on several variables (Manly, 1998; Hair *et al.*, 1995). Therefore, the discriminant analysis is a statistical technique used to classify an observation into one of several a periori groupings dependent upon the observation's individual characteristics. It is used primarily to classify and/or make predictions in problems where the dependent variable appears in qualitative form, e.g., male or female, bankrupt or non-bankrupt, privatised, non-privatised,...etc.

The discrimainant analysis has been initially utilised by Altman (1968, 1971, 1977; 1981) by building a **Z**-Score model to discriminate between bankrupt and non-bankrupt firms. In the literature of finance, interests in this model, and the methodology itself, have continued in the work of Wilcox (1971), Edmister (1972), Deakin (1972), Blum (1974), Sinkey (1975), Taffler (1978, 1982, 1983), and Sudarsanam (1981).

Discriminant Function Analysis

It is sometimes useful to be able to determine functions of the variables $\mathbf{X}_1$, $\mathbf{X}_2$, ...,$\mathbf{X}_p$ that in some sense separate the *m* groups as well as is possible. The simplest approach involves taking a linear combination of the **X** variables

$$\mathbf{Z} = \mathbf{a}_1 \mathbf{X}_1 + \mathbf{a}_2 \mathbf{X}_2 + \ldots + \mathbf{a}_p \mathbf{X}_p$$

for this purpose, in such a way that **Z** reflects group differences as much as possible. Groups can be well separated using **Z** if the mean value changes considerably from group to group, with the values within a group being fairly constant. One way to choose the discriminant coefficients $\mathbf{a}_1$, $\mathbf{a}_2$,..., $\mathbf{a}_p$ in the index is therefore so as to maximise the *F* ratio for a one-way analysis of variance. Hence a suitable function for separating the groups can be defined as the linear combination for which the *F* ratio is as large as possible. When this approach is used, it turns out that it may be possible to determine several linear combinations for separating groups. In general, the number available is the smaller of $_p$ and *m*-1. This is one of the advantages of the linear discriminant analysis: that is the reduction of the analyst's space dimensionality, i.e., from the number of different independent variables **X** to m-1 dimension (s). As this study is concerned with only two groups, consisting of privatised companies on one hand, and non-privatised companies on the other hand, the resulted **Z** function is only one function (i.e., one-dimension analysis).

When the discriminant coefficients are applied to the actual ratio, a basis for classification into one of the mutually exclusive groupings exists. In this regard, the discriminant analysis technique has the advantage of considering an entire profile of characteristics common to the relevant observations (i.e., companies), as well as the interaction of these characteristics. The linear discriminant analysis has also the advantage of yielding a model with a relatively small number of selected measurements which have the potential of conveying a great deal of information (Altman, 1968, 1971, 1977).

The Z-score Model

The linear discriminant function with its **Z** index (**Z** model) is derived by using a Stepwise Linear Discriminant Analysis provided on the STATGRAPHICS Plus 3.1 package and SPSS package. This procedure, using a stepwise selection algorithm, is designed to develop a set of discriminating functions which can help predict grouping based on the values of other quantitative variables. As the total number of companies under consideration is thirty one companies, thirty one cases are used to develop a model to discriminate among the two levels of grouping, the privatised companies and non-privatised companies.

CONTRIBUTION OF THE STUDY

This study contributes to the literature of corporate governance through extending the current practices of corporate governance to address some of the non-financial aspects. Specifically, the contribution of this study can be stated as follows.

1. This study extends the domain of corporate governance by addressing some of the non-financial aspects of corporate governance such as corporate stakeholders orientation and corporate identity which are empirically examined. Therefore, they provide alternatives governance structures that are drawn from the literature of international business, sociology and economics. These issues are important to emerging markets, particularly at the level of public policy, considering that the institutional infrastructure in these markets is not relatively as strong as those of the developed countries.
2. This study contributes to doing business in emerging markets, particularly transitional emerging markets by building a statistical tool (Z-score model) for monitoring corporate transitional performance. Once again, this approach is very important to emerging market in transition considering that any institutional change requires monitoring the path of change in the first place.

LIMITATIONS OF THE STUDY

In general, this study is primarily concerned of examining non-financial aspects of corporate governance. As it is mentioned above this study has considered three basic issues that present alternatives governance structures, e.g., corporate stakeholders orientation, corporate identity, and monitoring corporate performance in transitional emerging market. Accordingly, the limitations of this study can be stated as follows.

1. This study does not examine the financial aspects of corporate governance. But the literature review is to draw some lessons from the financial aspects of corporate governance in international context.
2. Concerning the international perspectives of corporate governance structures, this study focuses on the U.S. and the UK as an examples of the Anglo-Saxon business system, Germany as an example of the Communitarian business system, and Japan as an example of the Asian business system. This classification is mot mutually exclusive considering that other countries have business aspects similar to those considered in this study. Nevertheless, the countries considered in this study show three distinct corporate governance aspects that exist in many other countries or may alternatively be adopted by other countries.
3. The three issues examined in this study are three alternative governance orientations out of other non-financial governance structures such as the internal aspects of corporate governance.
4. The **Z**-score model, as an approach used for monitoring corporate transitional performance in transitional emerging market, is applied to the Textile Sector in Egypt, which is basically a manufacturing sector. Nevertheless, this approach can be adopted in other business sectors such as the service industries.

PART ONE

THE CORNERSTONES OF CORPORATE GOVERNANCE: PERSPECTIVES FROM INTERNATIONAL BUSINESS SYSTEMS

INTRODUCTION

This part explores the current practices of corporate governance with special focus on the differences between business systems. It discusses the interrelationships between the agency problem and the corporate governance. In addition, it discusses the corporate governance mechanism as equivalent to practices of corporate finance. As the underlying current practices of corporate governance are inherent in the political-legal institutional orientations, the brief discussion of the political and legal perspectives of corporate governance is also discussed.

Chapter 1

Corporate Governance: An Overview

1.1 Introduction

This chapter introduces the underlying cornerstones of the current corporate governance practices. It first highlights some of the most common definitions of corporate governance. Then, it explains, in brief, the link between the 'agency problem' as it is simply a matter of conflicts of interests and the essence of 'governance.'

The chapter, then explores the financial consequences of the agency problem on the basis that the conflicts of interests between corporate managers and the owners of capital lead the former to favour the sources of financing that minimise the level of conflicts. In this concern, the use of financial tools, most commonly used in the literature of corporate finance, to exercise governance of a firm is affects by the political institutions orientations toward running the economy. This is why the current practices of corporate governance is considered as equivalent of practices of corporate fiancee.

Finally, the chapter discusses the consequences of the agency problem from a legal point of view. This discussion is to explore whether corporate law recognises the conflicts of interests, or the agency problem, in the best interest of the firm.

1.2 Definitions of Corporate Governance

The traditional literature of corporate governance provided number of definitions. Shleifer and Vishny (1997) state that corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects?.

Sheikh and Chatterjee (1995) define corporate governance as it is concerned with establishing a system whereby directors are entrusted with responsibilities and duties in relation to the direction of a company's affairs. It is founded on a system of accountability primarily directed toward the shareholders in addition to maximising shareholders' welfare.

Tricker (1984) argues that some of the management literature has confused the distinction between 'management of a company' and the 'governance of a company.' The management role is primarily perceived to be running the business operations efficiently and effectively which includes the product, design, procurement, personnel, management, production, marketing and finance functions within the boundaries of the company under which it trades.

However, Tricker states that the governance role is not concerned with running the business of the company, *per se*, but with directors giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations for accountability and regulation by interests beyond the corporate boundaries: 'if management is about running business; governance is about seeing that it is run properly. All companies need governing as well as managing.' Therefore, the process of corporate governance comprises four main principal activities, namely:

1. Direction, which is concerned with formulating the strategic direction for the future of the enterprise in the long-term.
2. Executive action applies to involvement in crucial executive decisions.
3. Supervision involves the monitoring and oversight of management performance.
4. Accountability, which is concerned with recognising responsibilities to those making a legitimate demand for accountability.

Maw (1994) suggests that some commentators take a very narrow view of the concept of corporate governance by referring to it as a 'fancy term' for the way in which directors and auditors handle their responsibilities toward shareholders. Others, however, use the expression as if it is synonymous with shareholder democracy. According to Maw: "Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges."

Sheridan and Kendall (1992) have advocated another definition of the term 'corporate governance'. They believe that good corporate governance consists of a system of structuring, operating and controlling a company in order to achieving the following objectives:

1. To fulfil the long-term strategic goals of the owners which, after survival, may consist of building shareholder value or establishing a dominant market share or maintaining a technical lead in a chosen sphere, or something else, but will certainly not be the same for all organisations.
2. To consider and care for the interests of employees, past, present and future, which comprises the whole life-cycle including planning future

needs, recruitment, training, working environment, severance and retirement procedures, through to looking after pensioners.

3. To take account of the needs of the environment and the local community, both in terms of the physical effects of the company's operations on the surrounding area and the economic and cultural interactions with the local population.
4. To work to maintain excellent relations with both customers and suppliers, in terms of such matters as quality of service provided, considerate ordering and account settlement procedures.
5. To maintain proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities.

Sheridan and Kendall (1992) believe that a well-run organisation must be structured in such a way that all the above requirements are catered for and can be seen as operating effectively by all the interest groups concerned. The concept of corporate governance advocated by Sheridan and Kendall embraces a wide spectrum of responsibilities which directors have toward their shareholders and other 'stakeholders' in the company including employees, customers, creditors, and suppliers. It appears from the latter definition that corporate governance is a wider concept. It includes the financial aspects of corporate governance, namely directors responsibility for the company's financial situation which in turn requires directors to have regard to the interests of the company's creditors and shareholders. Directors also have a broader responsibility concerning payment of excessive remuneration. It is maintained that the concepts of corporate governance also include the social responsibilities of companies toward other stakeholders who are otherwise known as the potential claimants on the corporation.

Monks and Minow (1995) define corporate governance as "The relationship among various participants in determining the direction and performance of corporations." They define the primary participants as the shareholders, the management (led by the chief executive officer) and the board of directors.

It is obvious that the definitions mentioned above incorporate both the financial and non-financial aspects of corporate governance. The definition presented by Sheridan and Kendall (1992) is more wider in its scope than the other definitions because it incorporates stakeholders' interests with the companies long-term performance. Therefore, this definition is the one adopted in this study.

1.3 Corporate Governance and the 'Agency Theory'

Corporate governance is viewed in the literature as a straightforward agency perspectives, sometimes referred to as separation of ownership and control, i.e., separation of finance and management (Shleifer and Vishny, 1997). Therefore, the fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment. The literature of corporate governance shows that the agency problem is serious. That is, possibilities of managers' discretion among various types of investors are high. Managers' discretion may take many forms such as gaining private benefits from accepting projects with negative, or at least non-competitive, NPV and the discretion towards allocating the firm's returns among the various types of financiers. In some cases, the managers' discretion may reach to the extent of consuming the firm's resources for achieving private benefits such as putting high stress on perquisites and/or, in some extremes, stealing from the firm.

1.3.1 The nature of the agency problem

The agency problem has provided the literature of corporate governance with a clear evidence that when it is less likely to put co-operation and co-ordination mechanisms in place, conflicts between managers' and capital suppliers' interests arise. The literature provides number of studies that present evidence that when managers have a stake or benefits in the firm, both of the firm managers' and shareholders' interests align. For example, Walkling and Long (1984) find that managerial resistance to value-increasing take-overs is less likely when top managers have a direct financial interest in the take-over deal via share ownership or golden parachutes, or when top managers are more likely to keep their jobs.

In contrast, when managers' interests are disregarded, they protect themselves at the expense of shareholders interests. For example, Ryngaert (1988) and Malatesta and Walkling (1988) find that, for firms who have experienced challenges to management control, the adoption of poison pills - which are devices to make take-overs extremely costly without target management's consent - also reduce shareholder wealth. These examples support the idea that having a stake in a firm motivate owners of the stakes to align their interests for the benefits of the whole firm.

The above reveals the conclusion that when managers have a stake in the firm, the agency theory turns out to be of little help in explaining the relationship between managers and shareholders. That is, a co-operative or a mutual benefits mechanism replaces the agency theory in explaining that relationship.

1.3.1.1 The standard models of agency

The most common standard models of agency embodied in the literature are: Contracts, Managerial discretion, and Incentive contracts. The following sections summarise each of them.

1.3.1.1.1 Contracts

The agency problem is an essential element of the so-called contractual view of the firm, developed by Coase (1937), Jensen and Meckling (1976), and Fama and Jensen (1983a,b). The essence of the agency problem is the separation of management and finance or as it is referred to in the literature 'separation of ownership and control'. An entrepreneur, or a manager, raises funds from investors either to put them in productive use or to cash out his holdings in the firm. The financiers need the manager's specialised human capital to generate returns on their funds. The managers need the financiers' funds, since he either does not have enough capital of his own to invest or else wants to cash out his holdings. But how can financiers be sure that, once they sink their funds, they get anything but a worthless piece of paper back from the manager? The agency problem in this context refers to the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects.

In most general terms, the financiers and the manager sign a contract that specifies what the manager does with the funds, and how the returns are divided between him and the financiers. Ideally, they would sign a complete contract that specifies exactly what the manager does in all states of the world and how the profits are allocated. The trouble is, most future contingencies are hard to describe and foresee and as a result complete contracts are not technologically feasible. But, practically, the uncertainty surrounding business decisions makes the future not easy to foresee by both of the managers and the financiers, hence, the contracts between them are to be incomplete.(Allen and Lueck, 1995; Al-Najjar, 1995; Hart, 1995; Aghion and Bolton; 1992; Bolton and Scharfstein, 1990). Therefore, because of these problems in designing their contracts, the manager and the financiers have to allocate residual control rights, i.e., the rights to make decisions in circumstances not fully foreseen by the contract (Grossman and Hart, 1986; Hart and Moore, 1990). The theory of ownership addresses the question of how these residual control rights are allocated efficiently.

The literature states that it is not possible for the financiers to have residual rights. As Shleifer and Vishny (1997) demonstrate, one could imagine a contract in which the financiers give funds to the manager on the condition that they retain all the residual control rights. Any time something unexpected happens, they get to decide what to do. But it is less likely this may quite work because the financiers are not qualified or informed enough to decide what to do- the very reason they hired the manager in the first place. As a consequence, the manager ends up with substantial residual control rights and therefore discretion to allocate funds as he chooses. There may be limits on this discretion specified in the contract and much of the corporate governance deals with these limits, but the fact is that managers do have most of the residual control rights.

In practice, the situation is more complicated. First, the contracts that the managers and investors sign can not require too much interpretation if they are to be enforced by outside courts. In the United States, the role of courts is more extensive than anywhere else in the world, but even there the so-called '*business judgement rule*' keeps the courts out of the affairs of companies (Charkham, 1994). In much of the rest of the world, courts only get involved in massive violations by managers of investors' rights (e.g., erasing shareholders' name from the register). Second, in the cases where financing requires collection of funds from many investors, these investors themselves are often small and too poorly informed to exercise even the control rights that they actually have. The '*free rider problem*' faced by individual investors makes it uninteresting for them to learn about the firms they have financed, or even to participate in the governance process (Charkham, 1994; Shleifer and Vishny, 1997). As a result, the effective control rights of the managers - and hence the room they have for discretionary allocation of funds - end up being much more extensive than they would have been if courts or providers of finance became actively involved in detailed contract enforcement.

1.3.1.1.2 Managerial discretion

As managers, practically, end up with significant control rights over how to allocate investors' funds, managers can expropriate investors. In many pyramid schemes, for example, the organisers end up absconding with the money. Managerial expropriation of funds can also take more elaborate forms than just taking the cash out, such as transfer pricing. For example, managers can set up independent companies that they own personally, and sell the output of the main company they run to the independent firms at below market prices. In the Russian oil industry, such sales of oil to manager-owned trading companies (which often do not even pay for the oil) are evidently common. An even more dramatic alternative is to sell the assets of the company to other manager-owned firms at below market prices. For example, the Economist (June 1995) reports that Korean chaebol sometimes sell their subsidiaries to the relatives of the chaebol founder at low prices. Zingales (1994) describes an episode in which one state-controlled Italian firm sold some assets to another at an excessively high price. The buying firm, unlike the selling firm, had a large number of minority shareholders, and these shareholders got significantly diluted by the transaction. In short, straight-out expropriation is a frequent manifestation of the agency problem that financiers need to address.

In many countries today, the law protects investors better than it does in Russia, Korea, or Italy. In the United States, for example, courts try to control managerial diversion of company assets to themselves, although even in the United States there are cases of exception that take the form of executive compensation or transfer pricing. For example, Victor Posner, a Miami financier, received in 1985 over $8 million in salary from DWG, a public company he controlled, at the time the company was losing money (Shleifer and Vishny, 1997).

Managers' expropriation of shareholders may take a serious form: managers entrenching themselves and staying on the job even if they are no longer competent or qualified to run the firm (Shleifer and Vishny, 1989). As argued in Jensen and Ruback (1983), poor managers who resist being replaced might be the costliest manifestation of the agency problem. Managerial opportunism, whether in the form of expropriation of investors or of misallocation of company funds, reduces the amount of resources that investors are willing to put up ex ante to finance the firm (Williamson, 1985; Grossman and Hart, 1986). Much of the subject of corporate governance deals with constraints that managers put on themselves, or that investors put on managers, to reduce the ex post misallocation and thus induce investors to provide more funds ex ante. Even with these constraints, the outcome is in general less efficient than would occur if the manager financed the firm with his own funds.

These constraints have a legal perspective: what is so-called 'managers' "duty of loyalty" to shareholders. This duty may prevent managers from exerting obvious deviation from shareholders' interests. While it is difficult to describe exactly what this duty obligates the managers to do (Clark, 1985), threats to take value-reducing actions unless one is paid off would surely violate this duty. But this only raises the question of why this legal duty exists at all if it prevents efficient ex post bargaining between managers and shareholders. As Shleifer and Vishny (1997) indicate, the reason for introducing the duty of loyalty is probably to avoid the situation in which managers constantly threaten shareholders, in circumstances that have not been specified in the contract, to take ever less efficient actions unless they are bribed not to. If the duty of loyalty to shareholders prevents the managers from being paid off for not taking self-interested actions, then such actions will be taken even when they benefit managers less than they cost shareholders.

1.3.1.1.3 Incentive contracts

When contracts are incomplete and managers possess more expertise than shareholders, managers typically end up with the residual rights of control, giving them enormous latitude for self-interested behaviour. In some cases, this results in managers taking highly inefficient actions which cost investors far more than the personal benefits to the managers. Moreover, the managers' fiduciary duty to shareholders makes it difficult to contract around this inefficiency ex post. A better solution is to grant a manager a highly contingent long term incentive contract ex ante to align his interests with those of investors. While in some future contingencies the marginal value of the personal benefits of control may exceed the marginal value of the managers' contingent compensation, such instances will be relatively rare if the incentive component of pay is substantial. In this way, incentives contracts can induce the manager to act in investors' interest without encouraging blackmail. Although such contracts may be expensive if the personal benefits of control are high and there is a lower bound on the manager's compensation in the bad states of the world. Typically, to make such contracts feasible, some measures of performance that is highly correlated with the quality of the manager's decision must be verifiable in court.

Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Jensen and Meckling, 1976; Fama, 1980; Eisenhardt, 1989). The optimal incentive contract is determined by the manager's risk aversion, the importance of his decisions and his ability to pay for the cash flow ownership up front (Ross, 1973; Stiglitz, 1975). Incentive contracts are indeed common in practice. A vast empirical literature on incentive contracts in general and management ownership in particular dates back at least to Berle and Means (1932), who argue that management ownership in large firms is too small to make managers interested in profit maximisation. Kaplan (1994a,b) in his comparative studies shows that the sensitivity of pay (and dismissal) to performance is similar in the United States, Germany and Japan.

Incentives contracts may not be an efficient solution to managers' expropriation of shareholders. In fact, high powered incentive contracts create enormous opportunities for self-dealing for the managers, especially if these contracts are negotiated with poorly motivated boards of directors rather than with large investors. Managers may negotiate for themselves such contracts when they know that earnings or stock prices are likely to rise, and this may raise a possibility for manipulating accounting numbers and investment policy to increase their pay. For example, Yermack (1997) finds that managers receive stock option grants shortly before good news announcements and delay such grants until after bad news announcements. Therefore, these results suggest that options are often not so much an incentive device that can prevent managers from self-dealing, thus expropriation of shareholders.

The above high possibilities of managers' opportunism, especially with high powered incentive contracts, led the courts and regulators to look at these contracts with suspicion. Fortunately, in the United States, managers' opportunism, or self-dealing, and pay are ruled by courts, although the '*business judgement rule*' that govern the attitude of American courts toward agency problems keeps the courts out of corporate decisions.

1.4 The Financial Structure of Corporate Governance

The financial structure of corporate governance describes the financial tools available to finance the corporate operations and the financial mechanisms through which the governance process is carried out. The conventional tools are Debts Financing and Equity Financing. The following sections describe the nature and the scope of each.

1.4.1 Corporate governance through *Debt Financing*

This mechanism is a financing decision, made by a firm, to choose between debts and equities for financing its operations. The choice of one of them, or even both, subjects the firm to specific control rights practised by the financiers. Firstly, debt is a contract in which a borrower gets some funds from the lender, and promises to make a prespecified stream of future payments to the lender. In addition, the borrower typically promises not to violate a range of covenants such as maintaining the value of the assets inside the firm (Smith and Warner, 1979). If the borrower violates any of covenants, and especially if he defaults on a payment, the lender gets certain rights such as the ability to repossess some of the firm's assets (collateral) or the opportunity to throw the firm into bankruptcy. An essential feature of debt, then, is that a failure by the borrower to adhere to the contract triggers the transfer of some control rights from him to the lender.

Gale and Hellwig (1985) consider models in which the borrower can abscond with the profits of the firm. However, if the lender is not repaid, he has the right to investigate the books of the firm, and grab its cash before the borrower can steal it. Thus failure to repay triggers the transfer of control over the assets from the borrower to the lender. Gale and Hellwig (1985) show that the optimal contract that minimises the expected investigation costs is a debt contract. Grossman and Hart (1982) and Jensen (1986) model the role of debt in committing the payment of free cash flows to investors. In Grossman and Hart (1982), in particular, default enables creditors to deprive the manager of the benefits of control. Myers and Majluf (1984) show that, because management has superior information, external finance is costly. Moreover, they argue that this adverse selection problem is minimised by the issuance of the "safest" security, i.e., the security whose pricing is least sensitive to the manager's private information. Thus highly rated debt with a fairly certain payoff stream is issued before equity, since equity is difficult to price without knowing the precise value of the firm's assets in place and future growth opportunities. Debt is particularly easy to value where there is abundant collateral, so that investors need only concern themselves with the value of the collateral and not with the valuation of the entire firm, as equity investors would need to.

Aghion and Bolton (1992) use incomplete contract theory to characterise debt as an instrument whose holders take control of the firm in a bad states of the world. They show that if the managerial benefits of control are higher in good states of the world, then it may be efficient for managers to have control of assets in good states, and for creditors to have it in bad states. Bolton and Scharfstein (1990) present a model in which upon default, creditors have enough power to exclude the firm from the capital market, and hence stop future financing altogether. Hart and Moore (1994) explicitly model the idea that debt is a contract that gives the creditor the right to repossess collateral in cases of default. Fear of such liquidation keeps money flowing from the debtors to the creditors. Hart and Moore's models of debt show exactly how the schedule of debt repayments depends on what creditors can realise once they gain control.

Several other articles model the costs and benefits of the debt contract. The benefit is usually the reduction in the agency cost such as preventing the manager from investing in negative NPV projects, or forcing him to sell assets that are worth more in alternative use. The main costs of debts are that firms may be prevented from undertaking good projects because debt covenants keep them from raising additional funds, or else they may be forced by creditors to liquidate when it is not efficient to do so. Stulz (1990), Harris and Raviv (1990), Diamond (1991) and Hart and Moore (1995) present some of the main models incorporating these ideas, whereas Lang *et al.*, (1996) present evidence indicating that leverage indeed curtails investment by firms with poor prospects.

1.4.2 Corporate governance through *Equity Financing*

The second alternative for a firm to raise external finance is issuing shares which are the principal component of firm's equity holding. Shares are bought by both individuals whether they are small shareholders or large shareholders and institutions, i.e., institutional shareholders. Unlike creditors, individual shareholders are not promised any payments in return for their financial investment in the firm, although often they receive dividends at the discretion of the board of directors. Unlike creditors, individuals shareholders have no claim to specific assets of the firm, and have no right to pull their collateral (one commonly studied exception is mutual funds, in which individual equity holders can force a liquidation of their pro rata share of the assets and a repayment of its value). Unlike creditors, shareholders do not even have a final date at which the firm is liquidated and the proceeds are distributed. In principle, they may never get anything back at all.

In addition to some relatively weak legal protection, the principal right that equity holders typically get is the right to vote for the board of directors. Even this right is not universal, since many countries have multiple classes of common stock, and hence equity holders with inferior voting rights get proportionately fewer votes than their financial investment in the company. Because concerted action by a large group of shareholders is required to take control via the voting mechanism, voting rights are of limited value unless they are concentrated. Moreover, concerted action is less likely because of the 'free rider problem.' That is, whatever the size of the group who are initiating a concerted action, still they are relatively small in comparison of the total shareholders. This weaken the probability of concerted action since the costs associated with the action are incurred by the small group while the benefits are distributed to the large group of shareholders. Most small shareholders do not even have an incentive to become informed on how to vote. Contacting and persuading a large group of small shareholders through the proxy mechanism is difficult and expensive, especially when the management stands in the way (Dodd and Warner, 1983).

In contrast, when votes are concentrated - either in a large share holding block or through a take-over - they are extremely valuable, since the party that controls the concentrated votes can make virtually all corporate decisions. Concentrated equity in this respect is more powerful than concentrated debt. The value of individual shares comes from the fact that the votes attached to them are valuable to those truing to control the firm., and the protection of minority shareholders assures that those who have control must share some of the benefits with the minority (Grossman and Hart, 1988).

One of the fundamental questions that the equity contracts raise is how - given the weakness of control rights without concentration - do firms manage to issue equity in any substantial amounts at all? Young firms, and firms with intangible assets, may need to equity financed simply because their assets have little or no liquidation value. If they are financed by debts, their managers effectively give full control to the bank from the start. This may be especially problematic when the firm's value consists primarily of future growth opportunities, but the bank's debt claim and unwillingness to take equity give it little interest in the upside and a distorted incentive to liquidate (Diamond, 1991; Hart and Moore, 1995). Rather than give away control to the bank, such firms often have highly concentrated equity ownership by the entrepreneur and a venture capitalist. This may pave the way for some dispersed outside equity ownership as long as minority rights are well enough protected. In this regard, it is worth to mention that because of extensive legal protection of small investors, young American firms are able to raise capital in the stock market better than firms elsewhere in the world (Shleifer and Vishny, 1997). In fact, equity financing is observed primarily for young, growing firms, as well as for firms in rapidly growing economies, whereas mature economies and mature firms typically use bank finance when they rely on external funds at all (Singh, 1995). In the same spirit, Rajan and Zingales (1995) show for the United States and several OECD economies respectively that debt finance is most common for firms with tangible assets.

This analysis of equity financing still leaves an important question open: how can firm raise equity finance in countries with virtually no protection of minority investors, even if these countries are rapidly growing? Singh (1995) provides some evidence on the importance of equity financing in LDCs, although some of his data on equity financing might include privatisations and equity exchanges within industrial groups, both of which often take the form of sales of large blocks and hence need not reflect any minority purchases. Gomes (1996) presents one possible explanation which is during a period of rapid economic growth, reputational effects and the prospects of coming back soon to the capital market sustain good behaviour until the requisite institutions and legal protections are put in place. Therefore, investors can count on reputation in the short run, and legal protection in the longer run when the firm's needs for access to capital markets are smaller. Korea, as one of the rapidly growing countries, presents another evidence where the rates of return on investment may exceed the rates of appropriation by insiders. However, another possibility is that speculative bubbles and investor opportunism are playing an important role in equity financing in rapidly growing economies.

1.4.3 Debt versus equity choice

Because the rights of creditors are clearer, and violations of those rights are easier to verify in courts, the existing literature has anointed debt as providing better protection to outside investors than equity. However the focus on large investors sheds new light on the relative powers of debt and equity. Specifically, debt and equity ought be compared in terms of the combination of legal protections and ease of ownership concentration that each typically provides.

First, does debt promote concentrated ownership? By far the dominant form of lending around the world is bank lending. Banks are usually large investors, who gain numerous control rights in the firm at the time of, or even before, default. For example, the main bank, as in Germany, can often take physical control of the firm's bank account - which resides at that very bank - if it misses a payment, thereby assuring fairly complete control of the firm by the bank without much involvement of the courts. This control is often guaranteed by direct equity ownership in the firm, as well as a large degree of monopoly power over any future credit extended to the firm (OECD, 1995). In contrast, American, Canadian and British firms make more extensive use of syndicated bank lending and even of public debt, in which creditors are fairly dispersed. Therefore, it is hard to believe that even debt holders in these countries, then corporate governance in terms of corporate finance, can reconcile poorly performing firms effectively enough.

But even when debt is not very concentrated, the effective legal protection afforded creditors is likely to be greater than that available to dispersed equity holders. The crucial feature of the creditors' legal rights is that concerted action by multiple creditors is not required to take action against a delinquent debtor. The legal obligation of the firm is an obligation to each and every creditors, and of these creditors can typically sue the firm for payment of what is owed or for sale of assets. Of course, once action is taken by one creditor, the other creditors and the courts will take action to ensure that the first creditor does not grab a disproportionate share for himself.

Unlike equity, debt in a peculiar way may be tougher when it is not concentrated. If a borrower defaults on debt held by a large number of creditors, renegotiating with these creditors may be extremely difficult, and the borrower might be forced into bankruptcy (Bolton and Scharfstein, 1996). In contrast, it may be easier to renegotiate with a bank. The difficulty of renegotiation, and the power of dispersed creditors, might explain why public debt is an extremely uncommon financing instrument, used only in a few developed countries, and even there much less than bank debt.

1.5 Corporate Governance: Political or Economic Inevitability?

1.5.1 Economic perspectives of corporate governance

The economic foundations of contemporary Anglo-Saxon corporate governance systems stem from the work of Berle and Means (1932) who both introduced an economic explanation of equity financing and portfolio diversification. For example, the current Anglo-American corporate ownership structure tells the economic story of how many small shareholders with small percentage holdings, and until recently, little voice in governance, came to be the dominant form of large business enterprise in the United States. According to Berle and Means, economies of scale made possible by new technologies required U.S companies at the turn of the century to become so large that their enormous capital needs could be satisfied only by selling stocks to many investors who, by and large, wanted diversified portfolios. Ownership was thus dispersed, thus shifting decision-making power over the firm from shareholders to professional managers. In addition, the dispersion of ownership that eventually resulted from equity financing determined that professional, salaried managers (with perhaps modest stock holdings) practised control of the daily operations of the firm. At that stage, the separation of corporate owners and professional managers provided a chance for large mergers as long as motives for expansion, and for more economies of scale, did suffice. The obvious consequence of the separation between owners and managers, as Berle and Means speculated, is the weakening managerial incentives and accountability. This, of course, has resulted in the current corporate governance mechanisms that both managers (i.e., corporate insiders) and owners (i.e., corporate outsiders) invented to balance the power, thus to reduce the informational gap, between them. But this balance has been always proportional, therefore, resulting in certain costs that are known in the literature as 'agency costs': the costs that are typically incurred by the relatively weak party; corporate insiders or outsiders.

For the large family-owned businesses that made up most of American industry at this time, founders, (or their heirs) wanting to cash out thus had only two basic choices: (1) they could sell their stocks into the securities market; or (2) they could merge with another firm, thus to let the stock market finance the merger. Indeed, the primary role of the securities market at the turn of the century was not to raise new capital, but to finance the massive mergers at the end of the 19th century and allow founders to cash out. Therefore, the role of the stock markets in the United States was a consequence of the political restrictions that did not enable banks and other financial institutions to contribute in financing the firm's capital requirements.

Then, over time, concentrated stock ownership dissipated into fragmented holdings as the heirs sold off the inheritance and the managers occasionally raised new capital in the public markets. Therefore, the resulting combination of a large-scale enterprise, a professional (non-owner) management, and fragmented, diversified stockholders shifted control of public corporations from shareholders to managers. In contrast to business enterprise in Europe and elsewhere, dispersed shareholders and concentrated management became the distinguishing characteristics of the large American firm.

The continued domination of the large public corporation in the U.S. suggests that the current corporate governance mechanisms, coming on top of intense competition in American product markets, worked to minimise the problems of the separation of ownership from control. For if the U.S. system had failed to adapt in a way that solved this governance problem, the current U.S. ownership structure would have been supplanted by a more efficient alternative. Therefore, the economic perspectives of corporate governance seems to advocate that survival implies efficiency - or at least greater efficiency than available alternatives.

The economic perspectives of corporate governance indicate some advantages of the separation of ownership and control. This separation proved functional and, in many cases, a major source of value in its own right (Lazonick, 1992). Good manager replaced often less motivated or sometimes incompetent heirs. Specialisation of risk-bearing and management meant that good managers did not need to have their own source of capital to get to run large enterprises. Nevertheless, separation via public stock markets was not the only plausible path (Roe, 1997). Some founders might have preferred that banks, insurance, or other financial institutions had instead become part owners of their businesses. Then the power of professional managers could have been balanced by financiers with large stakes and a continuing interest in the firm - much as happens in the small firms financed by U.S. venture capitalists.

1.5.2 Political perspectives of corporate governance

As the current literature of corporate governance deals with solely subjects of corporate finance, corporate governance and corporate finance are viewed primarily as economic matters. In this regard, the common sense refers to the financing goal as to secure funding for the corporation at the lowest possible cost; and to the governance goal as to maximise the value of the firm to its owners. The political role in shaping corporate governance structure is seen at the top of a nation's companies, where the board of directors, shareholders, and senior managers interact. This place is, practically, the outcome not just of economic evolution toward efficiency, but of political developments such as laws and regulations that organise corporate activities.

Considering that the current well-known corporate governance systems are those of the United States, Germany and Japan, the current debate on differences among these systems refers to the evolution of each system. A recent study by Roe (1994) concludes that political pressure dominated economic pressures to the extent that the current practices of corporate governance were, politically, inevitable outcomes. Roe (1997) argues that, although the economic view of corporate governance is correct, it is incomplete. Rather politics have a dominant role over economics in this perspective. That is, economics alone can not fully account for the evolution of the main current corporate governance systems (the American, Japanese, and German systems) into its present form. For the United States, politics, in the form of laws and regulations affecting commercial banks and other financial institutions, played a key role in fragmenting stock ownership beyond what was required to have big firms and well-diversified investors (Roe, 1997).

Roe (1997) summarises the historical legal restrictions that have circumscribed corporate finance in the United States. As he puts it:

> "From the middle of the 19th century onward, both state and federal laws restricted the growth and activities of the largest American financial institutions. U.S. commercial banks were prevented from branching rationally, and thus they lacked both the size and the information networks to fund big pieces of the capital required by the large American firms emerging at the end of the 19th century. Banks' products and portfolios were also restricted - most important, banks were barred from the securities business and from owning stock. U.S. insurance companies were barred from buying stock for most of this century. Mutual funds, thanks to rules established in the 1930s and 1940s, can not easily devote their portfolio solely to big blocks; and they face legal problems if they go into the board room. And, finally, pension funds can not take very big blocks without structural and legal problems; the big private pensions are under managerial control (not the other way around) and ERISA make it more comfortable for pension managers to avoid big blocks than to take them." (Roe, 1997: 8).

Roe (1997) indicates the political-legal restrictions that circumscribed banks' and insurers' involvement in corporate decision-making. As he explains, the New Deal legislation of the 1930s has resulted in The Glass-Steagall Act, which separated commercial banks from investment banks. But the most serious restrictions on both banks and insurers came well before the New Deal. For banks, they were in place at the end of the 19th century; for insurance companies, they came shortly after the turn of the century. The New Deal was important in confirming the financial and ownership structures that already prevailed. The political-legal restrictions in banking extend to U.S. banking branching. As Clair and Tucker (1989) put it:

> "for much of the its history, the United States has had a banking system like no other in the industrialised world. Since the early 1800s, the U.S. banking system has been highly fragmented, consisting of numerous small banks without extensive branch systems." (Clair and Tucker, 1989: 32).

This indicates that the States chartered their own banks, and the Congress, influenced by local interests, refused to charter national banks that could operate more extensively than the politically powerful local banks.

The consequences of U.S. banking geographic restrictions have been historically evidenced. Every few decades, the lack of diversification resulting from geographic restrictions caused a U.S. banking crisis. As Roe (1997) explains, this inspired some political leaders to propose nation-wide branching in order to strengthen the banking system. But, as happened when President Cleveland endorsed proposals to allow national banks to branch in 1895, the proposals were repeatedly blocked in Congress by well-organised unit bankers (bankers that operated from a single physical location). Indeed, the well-organised unit bankers not only stymied truly national branching for national banks, but induced congress to reduce the capital requirements for rural national banks. The result was the establishment of many new banks, thus adding to the banking crisis and further strengthening the anti-branching banker constituency. In terms of politics, having more weak, local banks meant there were more players willing to invest in political action to block creation of national financial institutions.

Roe (1997) does document the effects of political-legal restrictions on the Anglo-American banking activities not only in terms of geographic restrictions but also in terms of product restrictions. Roe (1997) argues that geographic restrictions on U.S. banks were crucial, product restrictions also played an important role-and they too were in place well before the turn of the century. The National Bank Act of 1863 and 1864 gave national banks only limited powers. Control of an industrial company was not even contemplated and, hence, out of the question. And, in 1892, when the controversy over whether national banks could own stocks got the attention of the Supreme Court, the ruling came down that the power to own stock was not listed in the Act, and so it was not granted.

The claim is that protection of the public interests underlies those legal restrictions. But, while the public interest goals of protecting financial institutions explain some legal restrictions, they do not explain all of them. Two major forces lie behind many of the restrictions. Firstly, American populism which works against large private accumulations of power. Secondly, interest group politics, such as local banks who gained from the early fragmentation of U.S. financial institutions. Therefore, politicians have played active role, considering their power in the Congress, in restraining the financial institutions' capabilities toward providing finance on the national basis, and in raising the costs to financial institutions of participating in the governance of large firms. For the United States, Roe (1994) argues that political preferences rather than economic efficiency shaped American corporate law, at least at the Federal level, through systematic discouragement of large investors. That is, banks, insurance companies, mutual funds and pension funds were all prevented from becoming influential in corporate affairs. In this regard, the political response to the 1980s take-overs can be viewed as a continuation of the promanagement and antilarge-shareholders policies (Grundfest, 1990; Jensen; 1993). For example, financiers like J. P. Morgan were able to play a major role in corporate governance at the turn of the century even without holding big blocks of stock, particularly when the client firms needed outside capital. Like modern-day venture capital and merchant bankers, Morgan and other influential investment bankers sat on corporate boards and participated in strategic decision-making. But this role proved to be short-lived, at least partly because political restrictions against large ownership concentration in the early 20th century, which induced Morgan and other bankers to keep low corporate governance profile.

Roe (1997) claims that U.S. politics had a negative effects on corporate efficiency. He argues that if U.S. corporations and their investors successfully adapted, it seems plausible that American laws reduced corporate efficiency and increased the cost of capital for some firms in some periods of U.S. history. Therefore, U.S. politics, laws and regulations influenced the forms of ownership and top-level governance of the American corporations.

For Germany and Japan, politics have also played an essential role in shaping the current corporate governance system in each to the extent that the political process accommodates the powerful interests in the economy rather than maximising social welfare. In both countries, politics had more impact on the structure of the corporation and the institutions that own them. Both countries have shaped their systems of powerful banks at the end of the 19th century, during the period of rapid economic growth and with strong support from the state. In both countries, the United States attempted to destroy the powerful financial institutions during the occupation after World War II, and in both countries it failed (Shleifer and Vishny, 1997). Moreover, once German banks became sufficiently powerful, they discouraged the introduction of disclosure rules, prohibitions on insider trading, and other protections of minority shareholders, thus making sure that these investors never become a significant economic or political force to protect their rights. As a consequence of this evolution, the legal system has been developed to accommodate the prevailing economic power, resulting in relatively high powerful banks.

The political-legal effects on the structure and scope of financial institutions are quite clear outside the United States. In this regard, different political structures have yielded different outcomes. Historically, undemocratic Japan did not have the same open political structure that made American populism such a potent force. Japanese interest group configurations also differed from those in the U.S., and the national political structure was less responsive to local banking interests than the American structure. Therefore, when the Japanese banking system faced a rash of failure in 1927, the Japanese authorities reacted by merging many banks into larger ones. Such mergers were one of the major steps in the evolution of the Japanese banks into the main banks that characterise the Japanese keiretsu. In this regard, the Japanese banks had the financial strength to be able to take equity positions in most large firms after World War II. Large stock purchases of industrial firms by groups of four or five Japanese banks and insurers then produced the Japanese keiretsu, the networks of cross-ownership and influence among both industrial and financial firms that have dominated the Japanese economy since the 1950s.

At that point, the differences in political insights between Japan and the United States were shown in the responses of the Japanese versus the American policy makers. The Japanese policy makers responded to the Depression-era banking crisis by concentrating finance through large banking mergers. At the same time, the American policy makers responded to their banking crisis by enacting deposit insurance (which was intended to protect small banks from larger competitors) and separating commercial from investment banking (to prevent concentration of power among the larger banking operations). In Germany, securities markets were stifled, mandatory co-determination was added, and a rigid corporate law was kept in place.

This American outcome was a result of influences of the U.S. politician in the Congress (Roe, 1997). Most members of the U.S. Congress, given the strength of their ties to their local districts, had an interest in keeping banks small and local. Small-town American bakers were influential people; and by exploiting the public sentiment against concentrated financial power, this interest group were consistently effective in Congress. On the other hand, the Congress strengthened the power of small banks by deposit insurance and other regulations that are designed to protect their ability to compete with larger banks at roughly the same time that an authoritarian Japan was concentrating its banking system.

The Anglo-American political-legal restrictions extended the role of insurance companies in corporate governance. As Roe (1997) indicates, the three largest American insurers at the time - Equitable, Mutual, and New York life - were growing so rapidly that they showed promise of developing into institutions that would rival the powerful German universal banks or the main banks in Japan. At the very least, they seemed ready to become much like the large modern British insurers, which hold considerable stock and play a more important governance role than their passive American counterparts. But in 1905 the insurance industry was rocked by scandal, revealing nepotism, insider financial chicanery, and bribery of legislatures. The New York legislature responded with a political inquiry, which came to be called the "Armstrong investigation" after the state legislator who chaired the committee. In 1906, new insurance laws barred insurers from owning stock, controlling banks, or underwriting securities. For the next 50 years, insurers were banned from owning any stock at all and serious deregulation of this ban on stock ownership by insurance companies did not begin until the 1980s.

Therefore, it is obvious that American politics limited the insurance industry to its core business of writing insurance and investing in debt. Today, although insurance companies have stock holdings that amount to about 5 per cent of the total market (which puts them a distant third behind mutual funds' share of about 10 per cent and pension funds' 30 per cent), they play a negligible role in corporate governance. As for the Anglo-American mutual funds and pension funds, the political influences on laws and regulations that govern these funds are less direct and clear-cut than those that constrained the historical structure of American banking and insurance. But such laws and regulations raise the costs of such funds becoming involved in corporate governance. For example, mutual funds face portfolio limits that restrict them in deploying much of their assets in big block ownership with boardroom influence. The few public exception seem to rise when a mutual fund, or a complex of funds, find itself with a sizeable block. For example, when Kodak was in crisis and Fidelity found that its group of funds owned about 7 per cent of the company, Fidelity became involved (Roe, 1997).

As for pension funds, although the laws governing such funds do not explicitly bar big blocks, then boardroom influence, such activities are deterred by the reality that deviate from prevailing practice expose themselves to greater business risks, then the threat of litigation (Roe, 1993a, 1994). Private pension funds are also typically under the control of the sponsor company's managements, and most senior managers have usually not supported strong corporate governance activity. By contrast, the public pension funds have been more active. For example, CalPERS and others have prodded boards to set up governance and review procedures (Wagster, and Prevost, 1996).

In sum, in most nations where the evidence is available, politics have favoured some form of organisation and ownership over others. In Germany, bank influence has been favoured, stock markets suppressed. In Japan, regulation blocked the growth of public capital markets and channelled post-war financing through banks. American political influences have favoured liquid public markets and small-town banks at the expense of concentrated finance.

1.6 The Corporate Legal Framework

The business legal framework describes the legal boundaries within which corporate operations are conducted. The traditional subject of corporate governance describes the business legal framework from the viewpoint of the laws and courts' practices that bound corporate financing decisions. For example, external financing is a contract between the firm as a legal entity and the financiers, which gives the financiers certain rights *vis-à-vis* the assets of the firm (Hart, 1995). If firm managers violate the terms of the contract, then the financiers have the right to appeal to the courts to enforce their rights. Much of the differences in corporate governance systems around the world stem from the differences in the nature of legal obligations that managers have to the financiers, as well as in the differences in how courts interpret and enforce these obligations.

In theory, the most important legal right shareholders have is the right to vote on important corporate matters, such as mergers and liquidation, as well as in elections of boards of directors, which in turn have certain rights *vis-à-vis* the management (Easterbrook and Fischel, 1983). In practise, however, voting rights turn out to be expensive to exercise and to enforce. In many countries, shareholders can not vote by mail and actually have to show up at the shareholders meeting to vote - a requirement that virtually guarantees nonvoting by small investors. In developed countries, courts can be relied on to ensure that voting takes place, but even there managers often interfere in the voting process, and try jawbone shareholders into supporting them, conceal information from their opponents (Pound, 1988).

In countries with weaker legal systems, shareholders voting rights are commonly violated. For example, Russian managers sometimes threaten employee-shareholders with layoffs unless these employees vote with the management, fail to notify shareholders about annual meetings, try to prevent hostile shareholders from voting based on technicalities, and so on. Besides, as Stalin noted, "it is important not how people vote, but who counts the votes," and managers count shareholders' votes. In addition, in Russia, courts have protected a large shareholder when a firm's management erased his name from the register of shareholders. It is obvious, therefore, that differences in corporate governance across countries are indicated by the differences in both of the legal extent and the courts' protection of shareholders voting rights.

Another phase of firm's legal boundaries is what is so-called '*duty of loyalty*'. In many countries, shareholders voting rights are supplemented by an affirmative duty of loyalty of the managers to shareholders. That is, managers have a duty to act in shareholders' interests. Perhaps the most common accepted element of the duty of loyalty are the legal restrictions on managerial self-dealing, such as outright theft from the firm, excessive compensation. Some legal restrictions on managers constrain their actions by, for example, demanding that managers consult the board of directors before making major decisions, or giving shareholders appraisal remedies to stop asset sales at low prices. Other restrictions specify that minority shareholders be treated as well as the insiders (Holderness and Sheehan, 1988b). On the other hand, courts should play an active role in enforcing managers' duty of loyalty. Managers may rely heavily on the '*business judgement rule*' to interpret this duty from their personal point of view, to achieve personal benefits. Although the duty of loyalty is accepted in principle in most OECD countries, the strictness with which the courts enforce it varies greatly. In the United States, courts would interfere in cases of management theft and asset diversion, and they would surely interfere if managers diluted existing shareholders through an issue of equity to themselves. Courts are less likely to interfere in cases of excessive pay (Jensen, and Murphy, 1990), especially if it takes the complex form of options contracts, and are very unlikely to second guess managers' business decisions, including the decisions that hurt shareholders. But shareholders in the United States have the right to sue the corporations, often using class action suits that get around the free rider problem, if they believe that the managers have violated the duty of loyalty. Therefore the United States is generally viewed as relatively tough on managers in interpreting the duty of loyalty, although Bebchuk (1985) believes it is not tough enough.

In France the doctrine of corporate opportunities, which prohibits managers from personally profiting from business opportunities that are offered to the corporation, is not accepted by courts. Outside the United States and Canada, class action suits are not generally permitted and contingent fees are prohibited. Outside the OECD, the duty of loyalty is a much weaker concept, at least in part because courts have no capability or desire to interfere in business (OECD, 1995).

Because large shareholders govern by exercising their voting rights, their power depends on the degree of legal protection of their votes. Majority ownership only works if the voting mechanism works, and the majority owner can dictate the decisions of the company. This may require fairly little enforcement by courts, since 51 per cent ownership is relatively easy to prove, and a vote count is not required once the majority shareholder expresses his preferences. With large majority shareholders, matters are more complicated, since they need to make alliances with other investors to exercise control. The power of the managers to interfere in these alliances is greatly enhanced, and the burden on courts to protect large shareholder rights is much greater. For this reason, large minority share holdings may be effective only in countries with relatively sophisticated legal systems, whereas countries where courts are really weak are more likely to have outright majority ownership.

Legal protections extend to the second group of financiers, the creditors. These legal protections may include the right to grab assets that serve as collateral for the loans, the right to liquidate the company when it does not pay its debts, the right to vote in the decision to reorganise the company and the right to remove managers in reorganisation. Therefore, legal protection of creditors is often more effective than of the shareholders, since default is a reasonably straightforward violation of a debt contract that a court can verify. On the other hand, when the bankruptcy procedure gives companies the right of automatic stay of the creditors, managers can keep creditors at bay even after having defaulted. Repossessing assets in bankruptcy is often very hard even for the secured creditors. With multiple, diverse creditors who have conflicting interests, the difficulties of collecting are even greater, and bankruptcy proceedings often take years to complete (Weiss, 1990). Therefore, this makes debt a less attractive financing instrument to begin with (Bolton and Scharfstein, 1996). Still, while costly to the creditors, bankruptcy is very tough on the debtor firms as well, since their managers typically get fired, assets liquidated, and debt kept largely in place. Creditors' legal rights are thus enforced in a costly and inefficient way, but they are enforced. Again, these legal protections vary across countries. For example, because bankruptcy procedures are so complicated, creditors often renegotiate outside of formal bankruptcy proceedings both in the United States (Gilson *et al.*, 1990) and in Europe (OECD, 1995). The situation is worse in developing countries, where courts are even less reliable and bankruptcy laws are even less complete. The complications and inefficiency of existing bankruptcy procedures raised the possibility of using the debt-equity swaps to avoid complicated negotiations. That is, converting all the claims of a bankrupt company into equity, and then allowing the equity holders to decide what to do with the bankrupt firm (Bebchuk, 1988; Aghion *et al.*, 1992). It is possible that in the long-run, the debt-equity swaps will reduce the cost of enforcing creditors rights.

In sum, the extent of legal protection of investors varies enormously around the world. In some countries, such as the United States, Japan and Germany, the law protects the rights of at least some investors and the courts are relatively willing to enforce these laws. But even in these countries, the legal systems leaves managers with considerable discretion. In most of the rest of the world, the laws are less protective of investors and courts function less well and stop the clearest violations of investor rights. As a result, legal protection alone becomes insufficient to ensure that investors get their money back (Shleifer and Vishny, 1997). The need for at least some legal protection is shared by all large investors. Large shareholders need courts to enforce their voting rights, take-over artists need court-protected mechanisms for buying shares and changing boards of directors, and creditors need courts to enable them to repossess collateral. The principal advantage of large investors (except in take-overs) is that they rely on relatively simple legal interventions, which are suitable for even poorly informed and motivated courts.

In much of the rest of the world, legal protection of investors is less substantial, either because laws are bad or courts do not enforce these laws. As a consequence, firms remain family-controlled and, even in some of the richest countries, have difficulty raising external funds, and finance most of their investment internally. For example, in Italy, Pagano *et al.*, (1997) report the extraordinary difficulties that Italian firms face raising outside finance. As an evidence, over an eleven year period between 1982 and 1992, only 123 firms went public in Italy, compared to several thousand in the United States. The same difficulties exist when raising external finance from banks. (Barca, 1996) reports a significant amount of bank financing in Italy, most of it comes from state bank financing. Therefore, the conclusion that can be drawn that in Italy most large firms not supported by the government are family controlled and internally financed.

Although there is little systematic evidence available, most of the world appears to be more like Italy than like the United States, Germany or Japan (Shleifer and Vishny, 1997). For example, a recent study of India shows that large firms tend to be family controlled, and to rely almost entirely on internal financing except when they get money from the government (Khanna and Palepu, 1997). Latin America firms also face little external corporate governance, and financing tends to be either internal or from the government-controlled banks.

1.7 The Legal Embeddedness of Corporate Autonomy

The concept of 'stakeholding company' began to emerge in company law in the 1980s. The idea of corporate autonomy can be traced to two principal sources: the legal doctrine of separate corporate personality and the so-called separation of ownership and control. (Davies, 1997). That legal doctrine asserts that the incorporated company has an entirely separate legal existence from that of its shareholders. This radical separation is reflected in the fact that, in law, shareholders have no direct proprietary rights to the company's property, only rights to their share. In the 1850s, the joint stock companies began to be conceptually cleansed of shareholders and seen, both in law and everyday consciousness, as entities in their own right with a completely autonomous existence (Ireland, 1996a).

Although most companies' practises seem to be directed to satisfy shareholders interests, any identification of the company with its shareholders was contingent. That is, various legal rules - such as those concerning fiduciary duties and those giving shareholders control of the General Meeting and the right to appoint and dismiss directors - theoretically ensured that companies were controlled by and operated in the interests of their shareholders. However, with the growing separation of ownership and control, this contingent link is called into question. That contingency was realised since the writings of Berle and Means (1932). They suggested that the autonomy of the corporation from its shareholders was being supplemented by the autonomy of its managers from shareholders control. Therefore, by casting doubts on the effectiveness of the mechanisms guaranteeing shareholder supremacy, the debate has left a permanent question mark over the claim that companies, already entities with an entirely independent existence, are controlled by, and operated in the interests of, their shareholders.

By the late 1980s, the literature of corporate governance has incorporated a revival of ideas that corporate and managerial autonomy could be mobilised to make companies more socially responsible and accountable (Parkinson, 1993). As the corporate law recognised corporations as autonomous legal entities, it follows that corporate directors are autonomous as well. This highlights the crucial role of the board of directors as an important factor that determines the corporate economic and social role in the society. Therefore, to the extent that the character of companies seemed to be largely determined by who controlled them, the composition of company boards appeared to be the crucial issue. In Britain, the Bullock report on *Industrial Democracy* highlighted the importance of the board of directors in a world of autonomous corporate legal entities (Ireland, 1996a). That is, corporate autonomy is, by law, accompanied by board autonomy. Therefore, the report targeted the board of directors as the agents of these autonomous and neutral corporate entities, proposing the appointment of equal numbers of workers and shareholders representatives on the board of large companies.

The central weakness of the proposals for a reconceptualisation of the company is their failure to analyse their own theoretical foundations. Like the idea of the socially responsible corporation that animated managerialism, they are ultimately premised on the radical autonomy of the company from its shareholders, believing that this autonomy can, with appropriate changes to company law and business culture, be exploited to ensure that the interests of all those with a 'stake' in the company are taken into account.

Because of the external constraints imposed by globalisation and by product, capital and share market, stakeholders are more modest in their claims than most of the managerialist predecessors. But the nature and limits of corporate and managerial autonomy and, in particular, its starting point, the doctrine of separate corporate personality, are still not subjected to close. That is, the complete expulsion of the capitalist shareholder from production was latent in the joint stock form (Ireland, 1996a).

Contrary to the orthodox view, the complete separation of company and shareholders effected by the modern doctrine of corporate personality was not, and is not, an inevitable and natural consequence of the act of incorporation. It was not until the latter half of the nineteenth century that incorporation came to be regarded as having this effect (Ireland, 1996b). Prior to this, while incorporation was seen as creating a separate legal entity, there was no suggestion that this entity was completely cleansed of shareholders.

Rather, as Ireland explains, incorporated companies were conceptualised as their shareholders merged into a legally distinct entity. This was vividly illustrated by the Joint Stock Companies Act 1856, section three of which declared that 'seven or more people' could 'form *themselves* into an incorporated company, clearly implying that they *were* the company, that it was made *of* them. It was also illustrated linguistically in the regular references to 'the company' as a 'they'.

However, from the mid century, joint stock companies, incorporated and unincorporated, were gradually conceptually cleansed of their shareholders, coming to be perceived, both in law and everyday consciousness, as things, entities in their own right with an entirely independent existence. By the time of the Companies Act 1862, people were being permitted to form incorporated companies, objects external to them. Companies were no longer made of people but by them. Linguistically, the company was now an 'it' emptied of shareholders. Moreover, Ireland shows the legal foundation of the complete separation of the company and its shareholders through the separation of the value of shares and that of company assets. As he explains, until 1830s, joint stock company shares were large in domination and relatively few in number with the result that there was no developed market for their purchase and sale. In the period between 1830 and 1870, the share emerged for the first time as an autonomous and independent form of property. Shares, thus, were redefined in law as an autonomous form of property independent of the assets of the company. They were no longer conceptualised as equitable interests in the property of the company but as rights to profit with a value of their own, rights which could be freely and easily bought and sold in the marketplace. Therefore, with the development of the share market, shareholders are no longer 'tied' to their share, nor to the companies of which they were members.

It is obvious that the assets were owned by the company alone, either through a corporation or, in the case of unincorporated companies, through trustees. The intangible share capital of the company had become the sole property of the shareholders. Moreover, with the legal constitution of the share as an entirely autonomous form of property, the externalisation of the shareholder from the company had been completed in a way not previously possible. A vital legal space had emerged between the joint stock company (the owner of the assets) and the shareholder(the owner of the shares). The company was now the sole legal and equitable owner and personification of *industrial* capital; the shareholders the sole owners of *money* capital. Moreover, this space emerged, as the courts recognised, in unincorporated as well as incorporated joint stock companies, for the shares of *all* joint stock companies were redefined. Thus, the autonomisation of the company, then of the shares, was a consequent of the modern company law (Ireland *et al.*, 1987). In addition, that autonomisation of the company and its shareholders enables us to understand the distinction, in company law, which lies at the heart of stakeholding models: the distinction between the 'corporate interest,' an interest in the productive utilisation of industrial capital and the shareholder interest - a money capital interest in the revenue generated by those industrial capital assets. The autonomisation implies that the return on the share and its fictitious capital value are both determined by the surplus generated by the productive utilisation of those assets.

It is in this context that many managerial advocates of stakeholding are re-emphasising the autonomy of the company as an institution and seeking to distinguish its interests from those of its shareholders, broadly endorsing the Kay and Silberston (1995) claim that the corporation has a life of its own and that directors should be viewed (legally and otherwise) as trustees of the corporate assets. However, unlike those managerialists who treated the company as an entirely empty vessel, modern stakeholders from business generally display an acute awareness of the nature and limits of corporate and managerial autonomy, implicitly recognising the company as the personification of industrial capital.

Another approach that shows the legal perspectives in corporate autonomy conceptualises the company as a 'nexus of contracts' (Parkinson, 1993). This approach has been used to argue that workers might seek to further their interests *vis-à-vis* the company through contract (Stone. 1993).

1.8 Conclusion

This chapter concludes that the existence of the 'agency problem' leads to managers discretion to finance corporate operations in such a way that can deter outsiders intervention in corporate affairs. It is obvious that the political institutions orientations plays an influential role in supporting or rejecting outsiders intervention in the corporate affairs.

It is worth to note that as long as corporate law does recognise a corporation as a separate legal entity, this supports the idea that corporate managers should focus on the sustainability of the company's long-term performance. This is what is to be explored in the next chapter which discusses the current corporate governance mechanisms and their link to corporate performance.

Chapter 2

Corporate Governance Mechanisms

2.1 Introduction

Corporate governance mechanisms are economic and legal institutions that can be altered through the political process. These mechanisms can also be described as contractual mechanisms used to address the agency problem. Chapter one has shown that the current practises of corporate governance are embedded in the literature of corporate finance. In this concern, this chapter discusses the role of the basic mechanisms described in the literature of corporate governance: the role of the stock markets, the role of the banks and the role of the boards of directors.

The discussion focuses primarily on an international comparative perspectives which show the differences between the basic business systems: the Anglo-Saxon, the Communitarian and the Asian business systems. The United States and the United Kingdom are considered as an examples of the Anglo-Saxon business system, Germany is considered as an example of the Communitarian business system, and Japan is considered as an example of the Asian business system. The countries chosen as an examples of each business system are not mutually exclusive. That is, there are other countries that can be included in each business system. Here, the researcher has chosen those countries as they are characterised by distinct institutional infrastructures which are useful to explore the different institutional alternatives that can be considered viable to emerging markets.

2.2 The Stock Market Governance Mechanisms

The role of the stock market in corporate governance describes the practices through which corporate financiers exert their influences on the corporate board, thus corporate decisions. This influence is referred to as investors control rights. These rights vary according to the structure of corporate ownership, i.e., the type and the size of the investors.

2.2.1 The Structure of shareholding: An international comparative perspectives

Investors can get more effective control rights by being large. When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted action by investors is much easier than when control rights, such as votes, are split among many of them. In particular, this concerted action is possible with only minimal help from the courts. In effect, concentration of ownership leverages up legal protection. In terms of international business systems, there are several distinct forms that share holdings can take. The following sections describe the common forms and the magnitude of corporate ownership structure in the Anglo-Saxon, Communitarian, and Japanese business systems respectively.

2.2.1.1 The Anglo-Saxon shareholding structures

From a political history point of view, the stock market has been considered a major supplier of capital in the Anglo-Saxon countries. This means that a significant part of corporate financing takes the form of shares traded in the stock market. The magnitude of share holdings determine the shareholders control rights (or governance), and ultimately the corporate governance mode. In most of the Anglo-Saxon economies such as the U.S. and UK, the norm is relatively high dispersed ownership. In the United States, for example, large share holdings, and especially majority ownership, are relatively uncommon - probably because of legal restrictions on high ownership and exercise of control by banks, mutual funds, insurance companies and other institutions (Roe, 1994). According to the NYSE statistics, in1990 the private shareholders hold 29 per cent of the U.S. equities in all – 19 per cent in hands of the general public and 10 per cent in the hands of the owner founders (Charkham, 1994).The situation in the UK is nearly the same. Individual shareholders are numerous – about 9.26 million according to PRO SHARE. Of all the UK shareholders 62 per cent own shares in privatised issues only; 7 per cent own only the free shares they were given with the abbey National flotation; and 10 per cent own shares solely through employee schemes. PRO SHARE estimate there are only 1.6 million shareholders with a portfolio of shares (Charkham, 1994).

The shareholders' rights do not differ significantly in the U.S. and the UK. The bundle of rights with which the shareholder is left include a share of money distributed as dividends; a share of any surplus if the enterprise in wound up; a vote in the election of those to whom its stewardship is entrusted – the directors; a supply of information as laid down by the Companies Act in the UK and the SEC in the U.S.; the right to subscribe when new capital is sought. A shareholder's main right is, of course, to dispose freely of stock at the best price. The most striking features that shareholders, unlike professional, lack the power or knowledge to monitor corporate and/or managers performance in details. They are not even enthusiastic to do so. That is, they have to face the 'free rider' problem: individually they would have to bear all the costs of actions whose benefits mainly accrued to others. The logical answer is for them to get together with other private shareholders and make common cause. Britain lacks a means of bringing this about. People are encouraged to own shares but not to combine to protect their interest: this is quite opposite to the situation in the U.S where the United Shareholders Association (USA) is set up to combine individual shareholder's dispersed power. In the U.S., shareholding can be relatively large. This can mean that one or several investors in the firm have substantial minority ownership stakes. A substantial minority shareholder has the incentive to collect information and monitor the management, thereby avoiding the traditional 'free rider problem.' The large shareholder also has enough voting control to put pressure on the management in some cases, or perhaps even to oust the management through a proxy fight or a take-over (Shleifer and Vishny, 1986). In the most extreme cases, large shareholders have outright control of the firms and their management with 51 or more percent of ownership. Therefore, large share holdings is the most way to align cash flow and control rights of outside investors. Large shareholders thus address the agency problem in that they both have a general interest in profit maximisation, and enough control over the assets of the firm to get their voice influential on corporate board's decisions.

The ownership in the U.S. can also be concentrated: holdings by families and wealthy investors are common than is believed (Demsetz, 1983; Shleifer and Vishny, 1986). In fact, Holderness and Sheehan (1988a,b) found several hundred cases of over 51 per cent shareholders in public firms in the United States.

As for the institutional investors, one study of Columbia University's institutional investor project shows that the institutional investors in the U.S. invested approximately 18.7 per cent in the U.S. total financial assets and 45 per cent in the total equities (Brancato, 1990). In addition, the study shows that major institutions held 45.92 per cent of the stock of the top twenty five companies. In fact, there has been a growth in the total assets, particularly a switch to equities, under the institutions' control: in 1950 it was 6 per cent, in 1981 it was 32 per cent, and in 1990 it was 39 per cent.

In the UK, partly because the UK's tax arrangements favour collective savings – particularly pension funds – the proportion of equity shares in the hands of those who administer them now predominates. According to the Central Statistical Office, by 1989, 30.4 per cent of the UK equities were held by pension funds, 18.4 per cent by insurance companies, 5.9 per cent by unit trusts and 3.2 per cent by other financial companies (Charkham, 1994). Once again, the diversification policy, including a tendency to keep up with the index, is favourable by institutional investors in the UK, the same as in the U.S. As more than two-thirds of the UK equities are in the hands of institutions, this may lead to the conclusion that institutional investors in both the U.S. and the UK do not play a proactive role in corporate governance.

2.2.1.1.1 The effectiveness of shareholders monitoring

In this section the researcher addresses the question of the extent to which the concentrated ownership, in comparison to individual dispersed ownership, is effective in influencing corporate decisions and performance.

The answer to this question has two basic perspectives: an economic perspectives and legal perspectives.

As for the economic perspectives, the role of the individual shareholders is still as Berle and Means (1932) described it. The underlying issue is that as corporations grew and required ever greater infusion of capital, ownership became dispersed to thousands of individual small shareholders who lacked the power or the commitment to hold corporations accountable. This fragmented ownership left effective control of the corporation with management – ownership and control became separated. Even though the board's role was to oversee management for the benefit of the shareholders (who elected the directors), the management itself chose the one slate of nominees, which presumably consisted of persons with whom the managers felt comfortable. Thus, although directors had a duty to shareholders, the board was essentially governed by a clubhouse ethos that tended to favour the managerial status quo. The board was generally collegial and supportive of management. Its practical role was to assure that no blatant excesses or abuses occurred. Shareholder's principal recourse with underperformance was to sell their interests. In theory, if enough shareholders wanted to sell their stock, the price would drop and management would get the signal (Millstein, 1995).

As for the institutional investors, one must look at them as agents to other small individual investors. In this sense, the institutional investors have the motive when investing in stock, which is maximum profits in a very short time horizon. The fact is nicely summarised by Charkham (1994) as he says:

> "It is quite wrong to suppose that anyone concerned with institutional investment wakes up in the morning with corporate governance in his mind as the determining issue in choice of manager, portfolio strategy, or stocks. What they want of course is profitable investment, and the traditional way of achieving it is through straightforward market operations. If a stock disappoints one sells (EXIT). This is the so-called Wall Street Walk." (Charkham, 1994: 206).

What differentiates between the institutional shareholder's investment policy and the individual shareholder's investment policy is that the former can not concentrate its investment in a few companies portfolios. It has to spread the risk through the common strategies of portfolio diversification (Longstreth, 1991). For example, one U.S. public pension fund has 1,400 stocks and does more than 8,000 stock transaction a year. Moreover, since 1985 the use of stock index futures and other derivatives by pension managers has more than doubled. That is, 34 per cent use futures of one kind or another, where the emphasis is not on companies but on market timing with very little regard for the constituent companies (Lowenstein, 1991). It seems that the more the institutional investors keep diversifying, the less they are able to monitor corporate and/or managers performance and the less the role they can play in corporate governance.

The passive role of institutional shareholders in the UK is apparent. The Institutional Shareholders Committee encourages companies to consult institutional investors as insiders, which leads to disclose some information about the companies policies, under the condition that the latter suspend their ability to deal in the company's shares. The situation does, however, remain unsatisfactory as shareholders quite properly refuse to receive information that might inhibit them from trading because they would be insiders (Charkham, 1994).

However, there are some empirical evidences of the large shareholders activity in the market for corporate control. Shivdasani (1993) shows that large outside shareholders increase the likelihood that a firm is taken over, whereas Denis and Serrano (1996) show that, if a take-over is defeated, management turnover is higher in poorly performance firms that have block holders.

This situation is also observed in some of the newly capitalist economies. The active role of large shareholders has created a reaction on the part of the corporate management. In this respect, in Russia, the role of management in dealing with the control of large shareholders is quite obvious. As one Russian investment banker has pointed out, a Western investor can control a Russian company with 75 per cent ownership, whereas a Russian investor can do so with only 25 per cent ownership (Shleifer and Vishny, 1997). This comment is easy to understand once it is recognised that the management can use a variety of techniques against foreign investors, including declaring some of their shares illegal, requiring super majorities to bring issues on the agenda of shareholder meetings, losing voting records, and so on. While managers can apply these techniques against domestic investors as well, the latter have more mechanisms of their own to protect their power including better access to other shareholders, to courts, as well as in some cases to physical force. The effectiveness of large shareholders, then, is intimately tied to their ability to defend their rights. This, again, raises the importance of both legal protection and large ownership for exercising good corporate governance.

As for the legal perspectives, Gilson and Kraakman (1992) explain in details that the U.S. law includes number of regulatory barriers that prevent, if not prohibit, co-operative electoral action by institutional investors to elect professional directors, thus eliminating the proactive role the institutional investors can play in corporate governance. Firstly, there are the Federal proxy rules: particularly Rule 14a-8 does not require a company to include an institutional investor's nominees for director in the company's proxy statement or to provide a place on the company's proxy card for shareholders to vote for such nominees. It is obvious, therefore, that the proxy rules operate to deter institutional investors from electing professional directors.

Secondly, there are the regulations of the Securities Exchange Act § 13 (d). The first of these regulations are Rules 13d-1 and 13d-2. Rule 13d-1 requires any shareholder, or group of shareholders, that acquires over 5 per cent of an issuer's stock to file a Schedule 13D statement with the SEC setting forth information concerning the beneficial owner of the securities, including the number of shares owned, and the purpose and method of finance of the acquisition. Rule 13d-2 requires that a Schedule 13D be amended in the event of a material change, including a change of one pre cent or more in the percentage of the issuer's stock held. Because most institutional investors do not own more than 5 per cent of an issuer's stock, this filing requirement seems irrelevant at first.

Thirdly, there are the filings under Hart-Scott-Rodino that includes Section 7A of the Clayton Act, which was added by Title II of the Hart-Scott-Rodino Antitrust Improvement Act of the 1976. In order to give federal enforcement agencies sufficient time to prevent anticompetitive acquisitions, this statute requires a party who intends to acquire a significant amount of an issuer's voting stock to file a lengthy notification form and wait thirty days before actually acquiring the stock. A broad exemption relieves institutional investors from the duty to comply as long as their acquisition is solely for investment purposes and involves less than either 15 per cent of the outstanding stock or securities valued at less than $25 million. As Gilson and Kraakman (1992) emphasis, the phrase "solely for the purpose of investment" requires that the holder have "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer. The Statement of Bases and Purposes, which accompanies both the exemption rule and the definition of the relevant terms, further states that "nominating a candidate for the board of directors" may constitute conduct inconsistent with an investment intent.

2.2.1.2 The German shareholding structures

The scene in the Communitarian economies is different. In Germany, large share holdings in some form are the norm. Large commercial banks play a substantial role in corporate governance. The German large commercial banks through proxy voting arrangements often control over a quarter of the votes in major companies, and also have smaller but significant cash flow stakes as shareholders or creditors (Franks and Mayer, 1994; OECD, 1995;

Schmidt *et al.*, 1997). In addition, one study estimates that about 80 per cent of the large German companies have an over 25 per cent nonbank large shareholder (Gorton and Schmid, 1996). In smaller German companies, the norm is family control through majority ownership or pyramids, in which the owner controls 51 per cent of the company, which in turn controls 51 per cent of its subsidiaries and so on (Franks and Mayer, 1994). Pyramids enable the ultimate owners to control the assets with the least amount of capital (Barca, 1996).

The German capital market has undergone two main courses of change. The first was in the 1980s and the second is in the 1990s. Firstly, in the 1980s the German capital market has been an underdeveloped institution. Its under development has been compared to the situation in the U.S. prior to the enactment of the Securities Act of 1933. As compared to other industrialised economies, Germany has a surprisingly small number of stock corporations. As of 1988, there were 2373 stock corporations in Germany, only 503 (21.2 per cent) of which were listed on one of the eight German stock exchanges. In 1987 and 1988, there were only twenty one and fourteen new listings, respectively, among which a large number are either family-owned or subsidiary firms with a minimal public float. It is estimated that only about thirty corporations are widely held with readily traded shares (Kim, 1995). Consequently, the underdevelopment state of the German capital market has created a lack of liquidity and compels the major shareholders, German banks, to exercise their voices (Coffee, 1991; Knauss, 1981).

Although Germany has a mandatory disclosure system, the market for corporate information and disclosure has been underdeveloped. Information on companies listed on the stock exchange is insufficient (Meier-Schatz, 1986; Kallfass, 1988). Even where disclosure requirements exist, liability for incomplete disclosure is less harsh than under U.S. securities laws (Dilworth, 1993). Dilworth points out that the reason for the lower level of protection of investors is most likely due to the fact that private persons do not participate in the German securities markets to as great as in the United States. This means that the system whereby companies describe their development in annual financial statements and quarterly reports has not been regulated. There are no generally accepted accounting principles or auditing standards comparable to those in the U.S. Nevertheless, Germany introduced the available accounting options to comply with relevant European Community Directives (Kim, 1995).

The empirical studies of the German stock market suggest that the Efficient Market Hypothesis meets its ultimate test in Germany (Kallfass, 1988). Moreover, in the 1980s, insider trading has been widespread and unregulated. The securities market is supervised by either the German federal bank (Deutsche Bundesbank) or one of the eight German stock exchange. Recently, Germany has begun to consider creating a central securities regulatory body where the German government has proposed adoption of comprehensive legislation aimed at establishing an effective and internationally recognised system to supervise German securities markets. Before that, the absence of governmental supervision of securities markets has greatly been compensated by the role of German banks as strict disciplinarians

(Dilworth, 1993). The underdevelopment of the German capital market also may be a result of the predominance of credit-based capital market, which in turn enhances the power of banks. This is the main characteristic of the German corporate governance mode: that is it dependence on banks' credit and the enterprises have maintained strong relations with their "house banks." Germany market capitalisation is a good indicator of the role of the stock market. In this concern, in 1992 Market Capitalisation/GNP was 20.44 per cent and in the 1997 it was only 26.22 per cent (International Financial Statistics, 1997).

Consequently, the German enterprises are more leveraged than their U.S. counterparts. In 1983, the equity-capital percentage in balance sheet terms was 20.9 per cent for all German firms, as compared with 63.4 per cent for U.S. firms (Kim, 1995). Kim further indicates that large industrial corporations had a much higher rate of self-financing: between 1963 and 1970, for instance, the self-financing rate for German stock corporations hovered between 70 and 80 per cent. However, they also rely upon the banks for access to various forms of external financing. In Germany, the banks handle most new issues of marketable securities (Cable, 1985). Moreover, banks have privilege to apply for admission of securities to trading on the exchange and they are very careful to avoid risky issues in their function as guarantors. As a matter of fact, the German capital market would have been an unreasonably risky place for investors without banks having this privilege because of the limited governmental regulations (Kallfass, 1988).

The trend of national stock market internationalisation in the 1990s had influenced national investment structures. In general, internationalisation invariably increases the proportion of voting rights held by foreign shareholders. In addition, foreign shareholders' interest in corporate performance is limited in that it is primarily tied to the stock price, not to the corporation's long-term business prospects. As for Germany, on one hand, the inactivity and lack of interest shown by foreign institutional investors, who are alleged to hold close to a 20 per cent stake in German corporation, are viewed as problems. The main concern is that decreasing attendance at general meetings will produce random majorities and facilitate unfriendly take-overs (Kübler, 1991). On the other hand, the European Community's financial market integration program is fundamentally changing the German capital market (Warren, 1990). More importantly, Germany is now addressing, with more vigour than ever before, the problem of insider trading in accordance with the European Community directive on insider trading. On 1st August 1994, the Securities Trading Act (Wertpapierhandelsgesetz) finally entered into force under which insider trading is a criminal offence punishable by fines or imprisonment of up to five years (Kim, 1995).

2.2.1.3 The Japanese shareholding structures

The Japanese corporate governance mode presents distinct features which are mainly closely related to the unique Japanese style of industrial organisation. The latter affects the ownership structure and corporate performance, both of which determine the corporate governance structure. In this regard, Lichtenberg and Pushner (1994) prove that equity ownership by financial institutions in Japan may effectively substitute for the missing external take-over market by resulting in monitoring and intervention which minimise the danger of lapses in productivity. In contrast, they found evidence that high levels of inter corporate shareholding insulate firms from their own problems, at the expense of firm performance. They also found a notable influence of insider ownership, but no evidence that the influence of financial institutions has diminished in the globalisation and prosperity of the 1980s.

In Japan, the major principals are financial institutions and other corporations. The former often hold debt as well as equity. Firms affiliated with financial "keiretsu" groups typically show a large ownership share by financial institutions and/or a high level of intercorporate shareholding among business group members. These affiliated firms represent about 61 per cent of the market capitalisation of the Tokyo Stock Exchange (Shale, 1990). While the shares of financial institutions and other corporations vary considerably across firms. Nakatani (1984) finds that the average level of financial institutions and corporate shareholding are similar among group affiliated and independent firms. Subsidiary firms, however, show lower institutional shareholdings and higher corporate ownership shares on average. Gerlach (1993) proposes an underlying structure of share ownership in Japan that is shaped by a "logic of intercorporate, strategic interests," where investors are concerned with a more complex set of goals than capital market returns. Gilson and Roe (1993) describe the Japanese ownership structure as a system of contractual governance which influence both corporate governance and industrial organisation. This system is intended to facilitate relational investments, of which financial capital is just one component. Cross-ownership can thus reduce the costs of information transfer and increase the incentives and means for intervention by stockholders. Kester (1991) argues that the Japanese corporate governance system has obviated the need for an external corporate control market. As Kester puts it:

> "It (Japan) has not needed such a market because of the efficiency with which the traditional Japanese corporate governance system has dealt with the trading hazards of the marketplace and the agency problems of large organizations." (Kester, 1991: 271).

Sheard (1989) also contends that the combination of main bank monitoring and interlocking shareholding effectively substitute for the "missing" external take-over market in Japan. It is obvious, therefore, that the Japanese system of monitoring and governance seeks to maximise value by supporting efficient long-term production relationships among financial and manufacturing firms. In Japan, although ownership is not nearly as concentrated as in Germany, large cross-holdings as well as share holdings by major banks are the norm (Prowse, 1992; Berglöf and Perotti, 1994; OECD, 1995). The role of the main bank is considered particularly important. Each bank can hold a maximum of 5 per cent of firm's equity by law (reduced from 10 per cent as of the end of 1987). Typically, there is one main bank that is responsible for monitoring the firm's business affairs and intervening in times of crises. The potential threat of bank take-over may play an important monitoring function when the financial system is viewed as a whole. One can not deny that in the Japanese practice there is a close positive relationship between the degrees of management freedom from bank control and the level of corporate rate profits. Nevertheless, in normal circumstances the main bank does not exercise explicit control over corporate policy or management selection (Aoki, 1990).

In contrast to the active reputation of institutional shareholders, Japanese corporate cross-shareholding relies on the premise of inactivity, leaving management unconstrained. Since interlocking corporate stockholding has developed to such a degree that the take-over of the firm through open bids is virtually impossible: management of the firm is free from the discipline exercised by stockholders through the stock market (Aoki, 1989). Corporate cross-shareholding developed with the express aim of deterring external take-over, and seems to have been successful, as take-overs remain rare in Japan (Lichtenberg, 1992). While this management freedom can enable improved long-range planning, it may also insulate management from positive external influences by keeping control in the hands of friendly fellow business group members.

2.2.2 Advantages and disadvantages of concentrated ownership

Advantages of concentrated ownership

As concentrated share holdings and a predominant controlling ownership seems to be relatively the norm around the most of the world, a recent literature presents an evidence of the active role of large shareholders in exercising corporate governance. In Germany, Franks and Mayer (1994) find that large shareholders are associated with higher turnover of directors. Gorton and Schmid (1996) show that bank block holders improve the performance of German companies in their 1974 sample, and that both bank and nonbank block holders improve performance in a 1985 sample. For Japan, Kaplan and Minton (1994) and Kang and Shivdasani (1995) show that firms with large shareholders are more likely to replace managers in response to poor performance than firms without them.

In most of the rest of the world, including most of Europe (e.g., Italy, Finland, and Sweden), as well as Latin America, East Asia and Africa, corporations typically have controlling owners who are often founders or their offspring.

Obviously, permanent large shareholders and banks, such as those dominating corporate governance in Germany and Japan, have some advantages such as the ability to influence corporate management by patient, informed investors. These investors may be better able to help distressed firms as well. As Charkham (1994) has shown, German banks are large public institutions that effectively control themselves. There is little evidence from either Japan or Germany that banks are very tough in corporate governance. Nevertheless, in Germany, large investor-oriented governance system discourages small investors from participating in financial markets.

The advantages of concentrated ownership can also be shown through the literature that links corporate large investors and corporate performance. Cantillo (1995) indicates that Pujo investigation, which prompted Morgan and other investment bankers to leave the many corporate boardrooms, the stock prices of Morgan's client firms declined. While the reasons for the decline could be several, one plausible interpretation is that the governance structure would be weakened, at least for a time. Adaptation, even if effective, usually is not costless: the stockholders at the time adaptation takes place pay a price.

Roe (1997) indicates the financial advantages of large investors: large investors can reduce a firm's cost of capital through reducing monitoring costs, information costs, and industrial organisation costs. As for monitoring costs, it is plausible to say that directors representing institutions with large blocks of stock would presumably have the means, and their institutions have the incentives, for more effective monitoring of managers in firms where these institutions invest their money in. In principle, monitoring and corporate governance should matter least in highly competitive markets with little fixed, long-term capital and lots of growth opportunities. In these markets, managers who destroy value, or fail to increase it fast enough, will be unable to raise capital for growth and eventually be replaced.

But when markets are concentrated, or the firm's fixed investments are large and its growth opportunities few, managers will be relatively free from competitive and capital market pressures. In that setting, managers who fail to use their capital efficiently need not face the consequences of error immediately: whether because oligopoly provides slack, or the firm has lots of long-lived capital in place, the firm can slowly waste away until one of the governance mechanisms kicks in to make managers do their job better, or replaces them. As for information costs, practices in the stock markets lead to the result that the higher the information costs are, the higher the firm's cost of capital. The idea is, when information about a company's strategy or prospects is complex or soft (i.e., difficult to quantify), management often finds it hard to communicate it to outsiders. Stockholders with small holdings - and the equity analysts who write research reports for them - may not have the incentives to spend much time trying to understand complex, technological information, so they might choose to ignore it and just look at the bottom line. And managers with good, but proprietary information would not want to reveal such information to the stock market because it could benefit their competitors. Therefore, in either event, the stock market never gets the information and, to the extent the market discounts share values for greater uncertainty (i.e., assumes the worst), information costs end up raising the firm's cost of capital.

Here the benefits of concentrated ownership can be realised. That is, these soft, complex and proprietary information may be more readily conveyed to those who sit regularly in the boardroom. In addition, the ability to communicate the prospective value of a high-quality and cohesive middle management team, or the import of technical data generated inside the firm, may well be greatly improved by regular, private interaction between large stable stockholders and managers. In this sense, concentrated ownership may be able to lower the cost of capital by reducing information costs. It is obvious that concentrated ownership structures can improve the flow of information from inside the firm to large shareholders, thus helping to deter the short-termism often seen in both managers' and investors' behaviour. The benefits of concentrated ownership can also be realised by avoiding the shortcomings of dispersed ownership and careless investors. In terms of the agency theory, managers as well may incur some agency costs resulted from deappreciation of their efforts. That is, if managers increase the long run value of the firm in ways that dispersed investors can not see right away, the managers may not get the benefits right away (say, in the form of bonuses or payoffs from short term stock options). Therefore, managers may pass up profitable investments with long term payoffs while blaming the short termism of the stock market. Here it is plausible to say that if the ownership is relatively concentrated enough, a mutual appreciation between managers and large investors is likely. In addition, large holdings give the owner the scale economies needed to justify investing in the capability to acquire and process complex information. For example, big block holders can afford to hire an engineering or marketing consultants that a small stockholder would not think of hiring.

As for industrial organisation costs, they refer to costs incurred in vertical integration where customers and suppliers are combined together in a single organisational unit. This vertical integration may reduce managerial accountability for each, thus lower incentives for efficiency. A promising alternative lies in the multiple cross-holdings of stock by customers and suppliers (Gilson and Roe, 1993; Roe, 1997). Roe (1997) states that:

> "A customer that partly owns, say, 5% of the stock of a supplier has less incentive to exploit the supplier than one who doesn't. A customer that is a 5% stockholder and sits on a supplier's board gets information with which to monitor management not just as buyer of the supplier's products, but also as a board member and stockholder. If the customer tried to take advantage of the supplier after the supplier has committed itself, a "Keiretsu-like" coalition of shareholders could intervene to stop the opportunism." (Roe, 1997: 19).

The above concentrated ownership may take another form: a third-party concentrated ownership. A third-party financier could cement these partial relationships by owning some of the equity of both the suppliers and the customers. In this regard, institutional investors are big enough to have block holdings of each of the suppliers and customers in a co-ordinated networks (Flath, 1996). As Roe (1997) suggests, that alternative, if it was adopted by the U.S. companies, could have resulted in another governance structure with better outcomes. Roe argues that, although there's evidence of this in Japan, one could also imagine a role for such arrangements in the U.S. Using such financing, for example, the pitfalls of the 1980s could have taken a somewhat different course. In the U.S. the choice has tended to be an "either/or" one, with possibilities lying only at the ends of the spectrum of independence versus integration. But, with third-party financing, some related companies might have been broken off from large vertical organisations, but networks of co-ordination could have been retained when it was important to do so.

Disadvantages of concentrated ownership

The benefits of large investors are theoretically clear: they have both the interest in getting their money back and the power to demand it. But there may be costs of large investors as well. That is, large investors are not diversified, and hence bear excessive risk (Demsetz and Lehn, 1985). However, the fact that ownership is so concentrated almost everywhere in the world suggests that lack of diversification is not as great a private cost for large investors to bear as relinquishing control.

As Shleifer and Vishny (1997) explain the costs of large investors, large investors may work within the context of the agency problem as well as dispersed shareholders do. That is, it is quite possible that the large investors represent their own interests, which need not coincide with the interests of other investors and stakeholders in the firm. In the process of using his control rights to maximise his own welfare, the large investor can therefore redistribute wealth - in both efficient and inefficient ways - from others. This cost of concentrated ownership becomes particularly important when others - such as employees or minority investors - have their own firm-specific investments to make, which are distorted because of possible expropriation by the large investors. In this regard, one of the potential costs of having large investors is a straightforward expropriation of other investors, managers, and employees.

This straightforward expropriation can be inferred from the literature. Large investors might try to treat themselves preferentially at the expense of other investors and employees. Their ability to do so is especially great if their control rights are significantly in excess of their cash flow rights. This happens if they own equity with superior voting rights or if they control the firm through a pyramid structure, i.e., if there is a substantial departure from one-share-one-vote (Grossman and Hart, 1988; Harris and Raviv, 1988). In this case, large investors have not only a strong preference, but also the ability not to pay out cash flows as pro-rata distributions to all investors, but rather to pay themselves only. Inefficient expropriation by large investors through pursuit of personal (non-profit-maximising) objectives is evidenced as well. That is, the literature provides some work that shows that shares with superior voting rights trade at a large premium, which gives an evidence of significant private benefits of control that may come at the expense of minority shareholders. Interestingly, the two countries where the voting premium is the lowest - Sweden and the United States - are the two countries for which the studies of expropriation of minorities have been made. Bergström and Rydqvist (1990) for Sweden and Barclay and Holderness (1989, 1992) for the United States do not find evidence of substantial expropriation. In contrast, the causal evidence provided by Zingales (1994) suggests that the expropriation problem is larger in Italy, consistent with a much larger voting premium he finds in Italy.

Morck *et al.*, (1988) present evidence on the relationship between cash flow ownership of the largest shareholders and profitability of firms, as measured by their Tobin's Qs. They found that profitability rises in the range of ownership between 0 and 5 percent, and falls afterwards. One interpretation of this finding is that, consistent with the role of incentives in reducing agency costs, performance improves with higher manager and large shareholder ownership at first. However, as ownership gets beyond a certain point, the large owners gain nearly full control and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders. Thus there are costs associated with high ownership and entrenchment, as well as with exceptionally dispersed ownership.

As Shleifer and Vishny (1997) explain, many countries do not do much to protect minority investors rights, yet have large investors in the form of families or banks. While this governance structure may control managers, it leaves potential minority investors unprotected and hence unwilling to invest. Perhaps for this reason, countries in Continental Europe, such as Italy, Germany and France have relatively small public equity markets. In this regard, the existence of large equity market in Japan despite the weak protection of minority investors is puzzling. The puzzle may be explained by the predominance of low powered incentives within large Japanese institutions or in the workings of reputations and implicit contracts in Japan. The Japanese example brings up a very different view of large investors, namely that they are too soft rather than too tough. This can be so for several reasons. First, large investors, whether shareholders or creditors, may be soft when they themselves are corporations with their own agency problems.

Another example is presented from Germany. Charkham (1994) presents an evidence of the relatively soft large investors (e.g., banks) and weak public stock market. The reason is that German banks virtually control themselves. Charkham points out that at general meetings in recent years, Deutsche Bank held voting rights for 47.2 per cent of its shares, Dresdner for 59.25 per cent, and Commerzbank for 30.29 per cent.

2.3 The Banks Governance

Banks, as well as large bond holders, are considered as an active players in corporate governance. The empirical evidence of their role is relatively small in comparison with the role of large shareholders. However, a significant role of banks in corporate governance is observed more in Japan and Germany than in the United States. Roe (1997) indicates a historical view of the role of the American banks in corporate governance. U.S. banks could not play a full range of roles because (national banks were limited to a single location) and limited powers (they could not own stocks). In the U.S. at the turn of the century, there were no financial institutions of sufficient size and geographical diversity to provide the bulk of needed capital directly to America's new large enterprises. For Japan, Kaplan and Minton (1994) and Kang and Shivdasani (1995) document the higher incidence of management turnover in response to poor performance in companies that have a principal banking relationship relative to companies that do not. For Germany, Gorton and Schmid (1996) find evidence of banks improving company performance (to the extent they hold equity) more than other block holders do in 1974, although this is not so in 1985. For the United States, De Long (1991) points to a significant governance role played by J. P. Morgan partners in the companies J. P. Morgan invested in the early 20th century. More recently, U.S. banks started to play a major governance role in bankruptcies, when they change managers and directors (Gilson, 1990).

As banking finance is quite substantial in Germany and Japan, the powers of the banks *vis-à-vis* companies are very significant because banks vote significant blocks of shares, sit on boards of directors, play a dominant role in lending and operate in a legal environment favourable to creditors. In other countries, especially where procedures for turning control over to the banks are not well established, bank governance is less likely to be effective as in Italy (Barca, 1996).

2.4 Corporate Governance through the Board of Directors

In this stage, it is important to determine the magnitude of the board of directors' influence over corporate decisions. That is, there is a need to examine the differences between the influences of the board of directors, in different business systems, on corporate decisions, thus its influence on the way the firm responses and interacts in the marketplace.

The structure of corporate boards in international contexts varies greatly ranging from two-tier supervisory and management boards in Germany, to insider-dominated boards in Japan, to mixed boards in the United States. In business, accountability is essential as a means of maintaining standards of competence. The question of board effectiveness in any of these countries has proved to be controversial.

2.4.1 The effectiveness of the board of directors: A comparative international perspectives

2.4.1.1 The U.S. board of directors: Advantages and disadvantages

The typical function of the U.S. board of directors is to check on management. Typically, the structure of the U.S. board of directors is formed when the shareholders elect the board. This means that the shareholders can propose a slate of their own. In practice, this seldom occurs and even when it does, it usually fails, which means that the American corporate board is single tier (Charkham, 1994). The board consists of executive directors, who are members of the management team, and nonexecutive directors, who are outsiders. Recently, the tendency has been for outside directors to constitute a significant minority or, more usually, a majority (Hart, 1995). It is very common to find that the Chief Executive Officer (CEO) is the only executive on the board. However, the CEO may have fellow executives on the board. Typically, these fellows are the president or the Chief Operating Officer, Financial Officer, or a senior vice-president.

As the CEO practically dominates the corporate power, his/her role on the overall direction of the firm has been examined by many works. Mace (1971) described the directors as merely 'Ornaments on a corporate Christmas tree.' More recently, Lorsch and McIver (1989) stated that directors have become more responsible than before because of litigation and public concern which means that directors who accept appointment to a board are not generally looking for troubles. Therefore, the relationship between the CEO and the directors he/she has appointed, or who have appointed him/her, makes this a natural attitude among members of the board. The directors' role is enhanced when take-overs threaten because these have given rise to so much litigation. What is different in the U.S. corporate governance system is that in the normal course of business, directors have little to fear from the courts because of the '*business judgement rule*.' That is, the courts are most reluctant to double-guess management decisions. This 'rule' may be enhanced if directors do not have significant shareholdings. Rock (1991) argues that because directors do not generally have significant shareholdings and do not depend on the shareholders, they lack any significant economic incentive to discipline management. To the extent that they are economically or psychologically dependent on management, they have significant incentives not to act as the shareholders' champion.

In the United States, boards, especially those dominated by outside directors, sometimes remove top managers after poor performance (Weisbach, 1988). However, a true performance disaster is required before boards actually act (Warner *et al.*, 1988). The general feeling in the U.S. among thoughtful commentators is that U.S. management is often not accountable enough. The board does not often work properly and shareholders, especially when they are dispersed and/or their shareholdings are fragmented, seldom work at all. The management may fear the market but its tendency will be to entrench and reward itself well enough to reduce the financial consequences of displacement (Lowenstein, 1988).

Jacobs (1991) refers to the problem of lack of communication between the board of directors and investors as another reason for the ineffectiveness of the U.S. board. Lack of communication prevents investors from understanding management's long-term goals and objectives. Shareholders trade stocks so often and hold such broadly diversified portfolios that they can not possibly keep up with the business activities of the companies they own. Because most U.S. investors are detached from the businesses they fund, they rely on outward manifestations of what is really going on within the company; namely, quarterly earnings and other accounting measures of performance. These numbers only measure the past and do not explain the future. When they are dissatisfied with corporate performance shareholders sell stock, rather than trying to discern the causes of poor performance and using their collective voice to communicate their concern to management. Jacob further explains that companies exacerbate the problem by staking their boards with directors hand-picked by top management and insulating themselves from the oversight traditionally provided by shareholders and lenders. In recent years, companies have consistently disenfranchised their owners: they want access to capital with no strings attached. But a lack of trust makes investors hesitant to fund projects with no visible results for extended periods of times.

The above suggests that there is a need to improve the boards to work better. In this concern, the Competitiveness Sub-Council Report (1993) states that boards should ensure they have processes in place which enable them to function independently in their task of monitoring and evaluating corporate performance. One of the key aspects in so doing is establishing appropriate procedures at the full board level to oversee the formulation and realisation of the long-term strategic, financial and organisational goals of the corporation. It is obvious that the report is trying to overcome the problems arise from the directors' myopic, self-interested behaviour. The other key aspect states that boards should establish criteria and procedures for evaluating their own processes and performance, as well as that of the CEO. These criteria should be based on a clear understanding of the board's accountability to shareholders and, as appropriate, to various other constituencies of the corporation. This criteria emphasises implicitly on the role of other constituencies, i.e., stakeholders in improving the board's awareness. This criteria, in conjunction with the emphases on the long-term strategic, financial and organisational goals, show what the U.S. board of directors lack to improve corporate competitiveness.

The effectiveness of the outside directors

An emphases has been put on the directors' monitoring role and the role of outside directors in enhancing the effectiveness of the U.S. board of directors. On one hand, it would hardly be reasonable to expect the executive directors to monitor themselves. On the other hand, the nonexecutive directors may not do a very good job of monitoring for several reasons. Allen (1992) explains how the corporate business is run by both of the inside directors and the outside directors. He states that one of the principal duty of the U.S. boards of directors is monitoring the performance of senior management in an informed way. Outside directors should function as an active monitors of corporate management, not just in crises, but continually; they should have an active role in the formulation of the long-term strategic, financial and organisation goals of the corporation and should approve planes to achieve those goals. They should as well engage in the periodic review of the short-term and long-term performance according to plan and be prepared to press for correction when in their judgement there is need.

For outside directors to assume a more active role in corporate monitoring may require implementing changes of many kinds. They must understand that their duty requires more of them than simply acting as advisers and requires more than acting once a crises has arisen, which assumes that they are to monitor the corporate performance on a long-term basis. In this concern, effective long-term monitoring also requires a sympathetic and productive relationship between the outside board members and the CEO and the acknowledgement by the CEO of the legitimacy of the monitoring role and its requisites.

The effectiveness of long-term monitoring can be realised when the outside directors have enough commitment of time and resources especially information, and sometimes independent advice. As it goes in the U.S. system, a few hours a quarter may satisfy the role of passive adviser in good times, but it is never sufficient to meet the obligation to act as a monitor. Furthermore, the demands of the director position are inconsistent with service on an impressively long list of boards. Finally, nonexecutive directors may owe their positions to management who proposed them as directors in the first place. As well as feeling loyal to management, they may want to stay in management's good graces, so they can be re-elected and continue to collect their fees (Hart, 1995). Non-executive directors may also represent companies that do business with this company; major purchasers or suppliers, the company's lawyers, ..., etc. This further compromises their independence (Weisbach, 1988).

2.4.1.2 The German and Japanese board of directors: Advantages and disadvantages

When the comparative effectiveness of the board of directors across different business systems is examined, the common factor of the comparison is to be due to differences in corporate law with regard to the main purpose(s) of corporation, therefore, what permits or prohibits a particular action. In this concern, trends incorporate law in both Europe and Japan favour a "community of interests" model of the corporation: a model of corporate governance that constituency statutes may encourage in the United States

(Wallman, 1990). A brief international overview reveals that much of the rest of the industrialised world has a different idea of "what the corporation is" and "whom it is for."

The "codetermination" corporate laws in Germany, which mandate employee representation on second-tier supervisory boards of directors that oversee lower-tier managing boards, apparently have proven successful (Buxbaum, 1991; Kübler, 1991). "Codetermination" in some ways resembles the approach recommended in constituency statutes, which do not require, but permit, board representation of employees and other nonshareholder interests (Orts, 1992).

In the UK, a country sharing many legal similarities with the U.S., a clause in the Companies Act provides as follows:

> "The matters to which the directors of a company are to have regard in the performance of their functions shall include the interest of the company's employees in general as well as the interests of its members." (Conard, 1991: 80).

Unlike most constituency statutes, it is obvious that considering the interests of employees is mandatory. More importantly, the European Community is poised to adopt corporate harmonisation of the laws of its member states and to institute a new 'European company.' The EC company law includes provisions permitting corporations to take into account interests beyond those of shareholders. As Kolvenbach (1990) writes:

> "The company law harminazation program of the European Community has as its principal components the coordination, safeguarding, protection and equivalence necessary to protect shareholders, creditors, customers, potential investors and, last, but not least, the employees of companies in the Member States." (Kolvenbach, 1990: 709).

As for the Japanese corporate governance mode, it also shares an affinity with constituency statutes. The typical large Japanese corporation is a coalition of stakeholders – suppliers, lenders, customers, shareholders – holding a complex blend of senior and junior, short-term and long-term, conditional and unconditional, implicit and explicit claims against the company (Kester, 1991). This shows that, in terms of head-to-head competition, the Japanese communitarian companies have been impossible to beat (Thurow, 1992). What is different in the Japanese corporate governance mode is that it is due more to cultural and historical, rather than legal, differences. Custom and perhaps a difference in ethics – along with a large dose of economics – are more responsible than law in shaping the development of the Japanese corporation (Coffee, 1991; Aoki, 1990).

The evidence on Japan and Germany (Kaplan, 1994a,b) similarly indicates that boards are quite passive except in extreme circumstances. Mace (1971) and Jensen (1993) argue very strongly that, as a general rule, corporate boards in the United States are captured by the management. The U.S. board' practices are a good example of the power of the CEOs. In theory, large firms elect the board of directors, and the board appoints the CEO. But the actual flow of power in the U.S. boards ran in reverse: the CEO recommended nominees to the board. Board members were typically either insider-employees or other CEOs with little reason to invest time and energy in second-guessing the incumbent CEO. The CEOs recommendation for the board went out to the shareholders, whose small shareholdings gave them little incentive (i.e., the free rider problem is an example) to find alternatives: they checked off the proxy card and returned it to the incumbents. In this fashion, the CEO dominated the election and the firm. In addition, although the balance of power may have shifted with the recent increase in shareholder and board-level activism, as recently as the 1980s, many directors continued to "*feel they are serving at the pleasure of the CEO-Chairman.*"(Lorsch and MacIver, 1989).

2.5 Non-Governing Corporate Finance

It is obvious that corporate governance mechanisms include a relatively high agency costs, which means conflicts of interests between managers and financiers still do exist to the extent that managers, in most cases, are in a good position to expropriate shareholders by taking decisions that benefit the managers rather than the shareholders. The puzzle is, despite the prevalence of agency costs, the external finance is prevalent in most of the developed countries, which means that investors, in some cases, do not mind to be apart of their money.

The literature of corporate governance presents two explanations for this puzzle. Both of them do not rely on governance insights, rather on the hope that investors will make money in the future. Firstly, the idea that firms and managers have reputation that, by losing it, they may not be able to raise external finance. In general, reputation-building is a very common explanation for why people deliver on their agreements even if they can not be forced to (Kreps, 1990). In the financing context, the argument is that managers repay investors because they want to come to the capital market and raise funds in the future, and hence need to establish a reputation as good risks in order to convince future investors to give them money (Shleifer and Vishny, 1997). Several articles have presented reputation-building models of private financing. Diamond (1989, 1991) shows how firms establish reputations as good borrowers by repaying their short term loans. Gomes (1996) shows how dividend payments create reputations that enable firms to raise equity.

Investors optimism give a explanation for why investors give their money to companies without receiving control rights in exchange. That is, when investors get excited about a company, they finance it without thinking much about getting their money back, simply counting on short run share appreciation. In practise, the prevalence of investors optimism has created what is so-called "Ponzi scheme" (Shleifer and Vishny, 1997). In this scheme promoters raise external funds sequentially, and use the funds raised from later investors to pay off initial investors, thereby creating an illusion of high returns. Even without Ponzi schemes, if investors are sufficiently optimistic about capital gains in the short run, and are prepared to apart with their money without regard for how the firm will ultimately pay them back, then external finance can be sustained without effective governance.

On the other hand, another schemes called "Pyramid schemes" have been an essential element of all major financial markets (Shleifer and Vishny, 1997). In this regard, most railroad booms in the world were financed by investors who had virtually no protection, only hope. These schemes commonly occur where legal protection of investors is weak. For example, Russia, as a transition economy, has a pyramid scheme called "MMM." In this scheme, millions of people subscribed to shares of a company that used the proceeds to advertise on television while running a Ponzi scheme. Investors optimism is illustrated also in the rapidly growing East Asian economies, where investors optimism about near-term appreciation lead them to overlook the weakness of the mechanisms that can force managers to repay investors.

2.6 Conclusion

This chapter highlights the basic institutional characteristics of corporate governance mechanisms in each business system. In general, the Anglo-Saxon business system is a stock market-driven system, which means that corporate performance is determined by outsiders who relate corporate performance to the stock market valuation. This is because their relatively dispersed ownership and the relatively high transaction costs do not allow them to scrutinise corporate performance on internal basis.

The German business system is characterised by relatively dominant role by banks' large ownership and the pyramids of family large ownership. The tendency towards corporate self-financing is observed as well. This allows the German business system to relatively internalise the evaluation of corporate performance.

The Japanese business system is characterised by a different capital structure: corporate cross-ownership. This affiliated structure of ownership results in what is so-called "keiretsu" groups, which entails financial and business reciprocal relationships. This results in corporate performance to be reciprocally evaluated as well.

In this concern, the role of the board of directors in each corporate governance system is crucial in determining the criteria against which corporate performance is to be measured. That is, the boards role is one of the determinants of corporate competitiveness.

CONCLUSION OF PART ONE

Part one focuses primarily on the current practices of corporate governance as equivalent to practices of corporate finance. The existence of the agency problem has resulted in measuring corporate performance according to transaction costs analysis which focuses on what can be easily and less costly measured. In this regard, it is worth to note that the differences between and among the three corporate governance systems are inherent in certain institutional infrastructure that affects the adopted corporate governance mode. In this sense, the common corporate governance practices tend to focus on only one aspect of conducting business affairs: the financial aspects. Although the financial aspects and criteria are important for measuring corporate performance, there are also additional aspects and measures that are to be focused on. This is the core of the part two of this study.

PART TWO

CORPORATE GOVERNANCE AND CORPORATE COMPETITIVENESS: AN INTERNATIONAL PERSPECTIVES

INTRODUCTION

This part empirically examines issues related to non-financial governance structures that may help companies to enhance their relative competitive position in the marketplace. In this sense, there is an extensive research done in the role of the stock market mechanisms, bank debt mechanisms, and the board of directors mechanisms in monitoring corporate management's incentives.

In general, the stock market financial control mechanisms are those stated in the market for corporate control. Bank control mechanisms are those stated in the role of bank loans in disciplining management including bankruptcy. The board mechanisms are those stated in the role of the board of directors in monitoring management such as adoption of poison pills, payment of Greenmail, Golden Parachutes, and management Buy-Outs.

The mechanisms mentioned above do not explore the contribution from business-social studies that provide an additional governance structures. The social-business studies draw attention to the influences of the collective and collaborative actions on corporate affairs. In addition, the most distinguished characteristic of the social-business studies is that they are common factors that affect corporate affairs in any international business system and they are effectual as well in any development stage.

In this sense, this part empirically examines two issues inherent in corporate social affairs: the corporate orientation towards its stakeholders interests, and the corporate orientation towards strengthening its identity, thus its relative competitive position in the marketplace. The last issue examined in this study is the monitoring of corporate transitional performance in Egypt on the basis that active monitoring ultimately enhances companies' relative competitive position and helps to avoid drastic social pitfalls in a transitional stage.

Chapter 3

Corporate Stakeholders, Performance and Governance: Empirical Evidence from the Banking Industry*

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* A version of this chapter is forthcoming in the *Academy of Management Journal*.

3.1 Introduction

The issue of shareholders versus stakeholders orientation has been debatable in the literature. The debate is intense in different business systems with different corporate orientations that stem from different institutional infrastructures. The scholars who examined the magnitude of this debate focused on the legitimacy of shareholders versus stakeholders supremacy. This resulted in an extensive theoretical frameworks to this issue rather than to its practicality. Accordingly this chapter examines the practical aspects of this issue.

The chapter begins with a brief legal view of corporate stakeholders orientation on the ground that a 'company' is a legal entity in the first place and its business affairs are to be conducted in accordance with legal boundaries. Here, the researcher discusses the role of the boards orientation in running the corporate affairs. As long as the differences in the institutional infrastructures in different business systems result in different corporate orientations, the banking industry, as a financial institution, was chosen to examine the practical aspects of corporate shareholders versus stakeholders orientation.

3.2 Corporate Stakeholders and Corporate Law

The idea of stakeholding seems to have first emerged in the 1960s, developing as a deliberate play on 'stockholders,' the American equivalent of 'shareholders' (Goodpaster, 1991; Jones, 1995). In the 1980s, the discussion of stakeholding company has centred on the responsibilities and duties of managers, with the proponents of stakeholding making a variety of different proposals for legal reform, most notably an extension of directors' fiduciary duties, board representation or voting rights for stakeholders groups, greater disclosure of corporate information, and severance payments for employees.

Handy (1994), for example, asserts that the 'modern corporation' is an 'existential company' with a life and future of its own, an end in itself not an instrument owned by others. It is apparent, therefore, that Handy rests his analysis on the fact that shareholders are not regarded in law as the owners of the company's assets, thus the company has to develop its own 'sense of identity'. In addition, he argues that the satisfaction of shareholders (mere 'financiers') is a corporate requirement but not a corporate purpose. Handy concludes that companies need to be 'reconceptulaised' as communities which need customers, suppliers, financiers and community support if they are to survive and prosper in the interests of all.

Another stakeholding model developed by Parkinson (1996) is advocating not the replacement of profit seeking with multiple, co-equal goals, but the adoption of constraints on profit seeking. In this regard, the Anglo-American labour lawyers support proposals to reconceptualise the company as a means to improving the lot of the workers: their renewed interest in the company law has been prompted by a growing awareness of the limitation of collective bargaining (Collins, 1993). Although these limitations had long been apparent, they have been exacerbated in recent years by the dramatic labour market changes brought about by the transition from a Fordist to a post-Fordist or flexible regime of production, prominent among them a decline in Union density and strength, a rise in job insecurity and a growth in the part-time or 'contingent' workforce. Here, labour law is one of the cornerstones in a stakeholding model that recognises the workforce as one of the corporate stakeholders. For example, Klare (1993), referring to the stakeholding debates taking place in the U.S. in the early 1990s, argued that labour law reform must close the representation gap, giving all employees some form of participation in enterprise governance. In his view, public and legal policies need to encourage new and revitalised forms of workplace representation that ensures that enterprises are structured and governed in a democratic manner, hence his support for the entrenchment of works councils similar to those found in Europe. In this context, he calls for a legal reconceptualisation of the corporation, arguing that radicals should seek an 'enlarge[d] vision of the firm to see it as a *political and social institution* with its own organisational and industrial relations dynamics'.

Collins' (1989) arguments are markedly similar to Klare's. Labour law 'as a vocation' seeks to address and to relieve a fundamental social and economic problem in modern society: the subordination of labour to capital, or of employees to employers. Like Klare, Collins expresses doubts that proposals based on contractual models of the company can achieve significant changes in the distribution of corporate power, advocating instead the use of 'an alternative organisational paradigm.' Collins argues that by promoting a perception of the productive organisation as a 'public institution' with responsibilities which go beyond the 'residual claims of capital,' it might be possible to force owners of capital to respect a social obligation to minimise the social costs of their action[s].' Crucially, such a reconceptualization would radically alter the status of employees, elevating them to members of the organisation to be treated with respect and consulted over corporate plans, and helped in the event of redundancy. It is clear that both Klare and Collins thus echo Handy's (1994) stakeholding assertion that there is a need 'to rethink what we mean by a company.' In this regard, the question is whether such a radical reconceptualization of the company is capable of achieving the desired goals. Ultimately, this is to be determined by the market forces, market organisation and, at the end, a proper political institutions' support.

Kay and Silberston are presenting another contribution to the stakeholders debate (Kay and Silberston, 1995). They point to recent corporate collapses, frauds and scandals, trying to paint a picture of managers liberated from direct shareholders control pursuing their own self-interest at the expense of the company. Drawing parallels with the totalitarian political systems of Eastern Europe before the fall of the Berlin wall, they suggest that large corporations are in the hands of self-perpetuating governing elites who defend themselves by claiming to act in the interests of the shareholders while fiercely resisting the shareholders' interventions. In Britain, they suggest that the only restraint on executive pay and perks appears to be the modesty of executives themselves, and that is a commodity in increasingly short supply.

Again, Kay and Silberston stress on the fact that shareholders are not, in law, the owners of the assets of companies, simply because they do not, and are not in a position to, exercise the rights of ownership as traditionally understood. In this context, they draw a clear distinction between the Anglo-American and the German and Japanese conception of the corporation. In both

Britain and America, corporations are seen as creations of private contract, as private bodies defined by set of relationships between shareholders principals and manager agents, a view which fails to recognise the reality of their independent existence.

In continental Europe and Japan, on the other hand, a more realistic view is adopted in which the large corporation is recognised as a public institution with personality, character and aspiration of its own and as an entity with a 'life independent from its shareholders or stakeholders. Therefore, managers are inclined to view the development of the company as an end in itself and corporate objectives are quite properly thought to 'encompass the interests of a wide range of stakeholder groups - investors, employees, suppliers, customers and managers. In this view, corporations are perfectly naturally perceived as social institutions with public responsibilities.

In effect, Kay and Silberston's argument is that by embracing a principal-agent conception of the company in which managers are meant to 'maximise shareholder value' and operate the company exclusively in their interests, the Anglo-American law fails fully to recognise the reality of the company's autonomous existence. They, therefore, advocate the adoption of a trusteeship model of corporate governance in which boards of directors are regarded, and regard themselves, as 'the trustees of the tangible and intangible assets of the corporation, rather than as the agents of the shareholders.' Directors' duties would be to 'preserve and enhance the value of the assets under [their] control and to balance fairly the various claims to the returns which these assets generate.' These assets would include the skills of the company's employees, the expectations of its customers and suppliers and its reputation in the community. They assert that, while the agency model 'expects the manager to attach priority to the current shareholder interest,' the manager as trustee would be expected to 'relate to the broader purpose of the corporation, and not simply to the financial interests of shareholders.' The trusteeship model, thus, embraces the German conception of the company as a 'social institution,' requiring the manager to 'balance the conflicting interests of current stakeholders and additionally to weigh the interests of present and future stakeholders.' More concretely, Kay and Silberston proposed fixed four-year terms for public company chief executive, the appointment of board chairs who are independent (in the sense of not receiving substantial remuneration from the company) and the appointment of at least three independent directors appointed only after proper consultation with stakeholders. Although they rule out supervisory boards along German lines, they hint that this model of corporate governance might entail adopting other 'noted institutions of the German social market economy.'

For Key and Silberston, the ultimate justification for the adoption of the stakeholding model is to be found not in legal theory but in economic performance. Stakeholding-organised companies are advocated not because they are more democratic or socially responsible, but because they are more competitive than those organised on more traditional Anglo-American lines. Nevertheless, the stakeholding model that Key and Silberston have developed is conservative because it advocates the idea that companies should not be asked to promote social welfare or to be particularly socially responsible, but to be 'good businesses.'

The idea of stakeholders addresses a number of pressing legitimation problems. At a time when many are unemployed or experiencing chronic job insecurity, for example, the recent scandals surrounding director's pay have become a growing embarrassment, creating an impression not only of managerial autonomy and unaccountability, but also of managerial greed. They have provided fertile ground for the advocates of business ethics, social audits and wider performance measures (Freeman, 1984; Preston and Sapienza, 1990; Wood, 1991a,b; Hill and Jones, 1992; Donaldson and Preston, 1995; Swanson, 1995; Mitchell *et al.*, 1997). Significantly, the Tomorrow's Company report is at pain to stress the competitive importance to companies of maintaining public confidence in the legitimacy of their operations and business conduct, and of the need to be able to respond rapidly to changing market conditions. That is, companies which are insensitive to changing standards, as the report observes, can find themselves at the centre of media and public outcry (Royal Society of Arts, 1995).

The above idea has to do with the ground roots of the different capitalism orientations. That is, corporate competitiveness should be adaptable enough to consider the strengths and weaknesses of the western capitalism. As Ireland (1996a) states:

> "...western capitalism is itself experiencing legitimation problems, despite its seeming economic and political inviolability and the growing acceptance of alleged market inevitabilities. Whereas in the past it derived legitimation from the successful provision of higher living standards, its very survival now appears to require mass unemployment or underemployment, poverty, homelessness, and the depression of living and working conditions." (Ireland, 1996a: 306).

The Economist (1996) highlights another phase of the weakness of the western capitalism, that from the White House to the Palace of Westminster the cry is going up that higher profits and productivity are failing to deliver the higher wages and job security they are supposed to. Therefore, the popularity of stakeholding, with its notion of partnership and of the caring socially friendly corporation, stems from being regarded as little more than the currently fashionable remedy for a growing legitimation crisis which is reflected by improperly run companies and insensitive managers.

Another important reason for the stakeholding popularity lies in the globalisation of markets and the ever faster technological change: the rules of the competitive race have been rewritten with rapidity of response and flexibility becoming increasingly crucial. Thus the advocators for reforming corporate law is considering that competitiveness organisational and managerial forms adopted by the enterprise are becoming among the crucial factors of corporate success. In this regard, Teubner (1994) argues that contemporary problems of corporate governance and legitimation might best be resolved by a radical autonomization of the corporation and its interests, not merely from its shareholders but from all of the 'resource-holding interest groups' associated with it. That is, Teubner builds his view on the differentiation of 'organisation' and 'contract' so as to encompass system and environment. He advocates that all corporate resource holders - meaning owners of capital, workers and management, as well as suppliers and customers - should be interpreted not as 'part of the organisation' but as part of its 'environment.' Thus the contractual network which links resource holders should be viewed as 'govern[ing] the external relationships between the environment of the organisation and its members.' According to Teubner, legal policy should direct its efforts at the institutional strengthening of the corporate actor (Teubner's term of corporate autonomy or company as an independent legal person). In this sense, corporate governance has been abstractly cast as one between 'flexibility through contract' and 'flexibility through organisation.' According to Teubner, flexibility through contract - which can be applied to methods of financing and technologies, as well as the employment of labour - is essentially premised upon dispensability, upon keeping a firm's long-term ties and commitments to a minimum so as to maximise its ability to respond rapidly and at short notice to changes and fluctuations in its environments.

But some argue that flexibility obtained in this way tends to undermine long-term relationships of co-operation, destroying 'organisational surplus value.' Only through deepened relationships with, and between, employees, customers, suppliers, investors and the community, companies will be able to anticipate, innovate and adapt fast enough and maintaining public confidence as well (Royal Society of Arts, 1995). In this regard, only by developing an 'organisational approach to flexibility,' the long-term relationships which enable the organisation to flourish will be preserved.

The above two alternatives of flexibility are viewed as a choice between 'Americanisation' and 'Japanisation,' or between the 'neo-American' and 'Rhine' model (Albert, 1993). The idea is that German and Japanese corporations, with their emphasis on the autonomous interest of the company and on its wider social duties and responsibilities, are competitively superior to their Anglo-American counterparts with their emphasis on shareholder rights and profits maximisation. Corporate competitiveness, therefore, is linked to a more stakeholding-oriented organisational and management arrangements by considering the modern methods of production, in which the nature and composition of industrial capital has undergone significant changes.

Tomorrow's Company report highlights those changes, thus their link to stakeholding-orientation perspectives (Royal Society of Arts, 1995). The report states that 'the centre of gravity in business success is shifting from exploitation of a company's physical assets to the realisation of the creativity and learning potential of all the people with whom it has contact.' Moreover, the report claims that the human capital and knowledge worker are becoming increasingly important to the extent that it demands a more 'inclusive' organisational structure and management style for outstanding businesses see continuity and stability in their relationship with employees, customers and suppliers as essential for a flexible and co-operative response to change. In this regard, Reichheld (1996) focuses on the importance for management to build long-term relationships with all corporate constituencies. Moreover, he warns against focusing narrowly on financial measures of short-term profits, and advocates 'loyalty-based management' which emphasises the long-term preservation of human capital from the pressures of raising short-term earnings.

3.3 Corporate Board-Stakeholders Orientation: A Case of Exploitation or Exploration?

The legal embededdness of corporate autonomy, viewing the company as a separate legal entity, does include that *non* of the corporate constituencies is attached to the corporate legal identity. This means that corporate managers are in a good position to consider what is in the best interest to the company as a whole. They are not obliged, by law, to act to the interest of one corporate group at the expense of the others. Therefore, a practical explanation for the differences among corporate managers' orientation in different industries and in different business systems can be found in the common practises in the market for corporate control. That is, managers who are focusing more on shareholders' interests than other corporate constituencies' interests are doing so merely because of their fear from take-overs, thus the fear that a new owners may dismiss them. This idea is shows in figure (3-1).

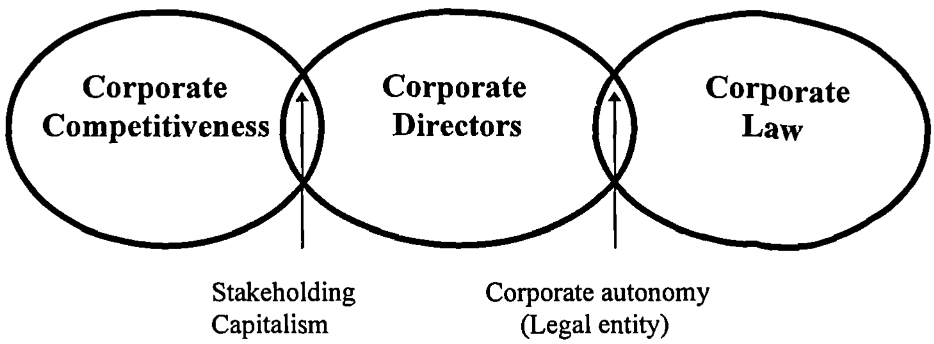

Figure (3-1): The board of directors and corporate law

Philip Goldenberg argues in Tomorrow's Company report (Royal Society of Arts, 1995) that not only is the traditional shareholder-only view of the firm mistaken (a historic misconception), but so too is the idea that stakeholding means serving the interests of shareholders, employees, customers and community equally (the modern misconception). Goldenberg emphasises on the view that directors' duties should be owed to the company as a separate entity, not to any third party group (Caulkin, 1996). Therefore, the fear from dismiss is a logic explanation for what is referred to, in the literature of corporate governance, as managers discretion behaviour, i.e., considering shareholders' interests as a high priority over other corporate constituencies' interests. Thus managers discretion behaviour is aiming at defending solely their interests in the company rather than the company's interests. In fact, this is a result from a dilemma in corporate law. That is, although the corporate law, as referred above in the legal embeddedness of corporate autonomy, does not recognise any of the corporate constituencies as owners of the company, it (corporate law) does, implicitly and practically, recognise shareholders the upper hand and/or the reference group in electing the board. Non of the other corporate constituencies, by law, has anything to do with electing the board. This is one of the main reasons that explains why corporate governance has been always attached to corporate finance.

In that context, shareholders power over electing the corporate board is the major characteristic of the Anglo-Saxon business system. But that power has alternative business strand which is observed in the other business systems that allow cross-holding, or cross ownership: this is the main characteristic in the German and Japanese business systems. In these two systems, the clients of a company, its suppliers, and even other companies in the industry are shareholders in that company. Here, when the company is considering the shareholders' interests, it is in fact considering other corporate constituencies' interests. Despite this orientation is still attaching corporate governance to corporate finance, it forces the company not to ignore the other corporate constituencies' interests. Therefore, the difference in ownership arrangements, ranging from concentrated ownership to dispersed ownership, are explained by differences in institutional arrangements. The latter, in the context of institutional analysis, have their origins in differences in the cultural orientation that made an institutional path dominant over other alternatives (North, 1996; Hirsch and Lounsbury, 1996). Therefore, there is a need to consider the effects of the cultural orientation on possible corporate governance arrangements: one of them is the 'stakeholding orientation.'

In this regard, Fukuyama (1995) highlights the importance of culture to international competitiveness. He embraces the claim that henceforth the primary identification of people will be cultural not ideological, extending it to argue that culture will be crucial to competitive success in the global economy. More specifically, he asserts that 'a nation's well-being, as well as its ability to compete, is conditioned by a single, pervasive cultural characteristic: the level of trust inherent in the society.'

The above thoughts about the role of trust in industrial organisation is relevant to the stakeholders argument, in a sense that stakeholding company is all about building long-term and mutually beneficial relationships with all corporate constituencies in a way that helps the company to respond and compete successfully (Hosmer, 1995). In that sense, Fukuyama shows the relevance of trust to industrial organisation through number of examples. Toyota, one of the forerunners of 'lean' production are able to delegate to workers great power, including the power to actually stop the production line, precisely because they know that their trust will not be abused. Similarly, the German workplace is flexible and egalitarian because workers trust their managers and fellow workers to a higher degree than in other European countries. Fukuyama, thus, claims that there is a need, both at the level of society as a whole and at the level of the individual firm, for a sense of community and solidarity, a sense capable of ensuring that people are motivated by something broader than individual self interest. There is a need for communities who 'share norms and values' and who are 'able to subordinate individual interest to those of large groups.' Economic success in the liberal democratic capitalism which constitutes history's end thus needs more than law, contract, rights, and rationality, it needs 'reciprocity, moral obligation, duty toward community and trust: certain premodern (not postmodern) cultural habits.'

At the level of the productive enterprise, this is particularly important in the post-Fordist era of flexible production precisely because of the increasing reliance in production on the knowledge, skills, adaptability of human beings and on rapid organisational innovation. Therefore, Fukuyama is supportive of certain forms of worker participation and democratisation, such as German-style works council, seeing them as giving institutional form to the 'idea of community of interest between workers and management.' In that sense, companies seeking to downsize might have to submit planes for compensating, retraining, or relocating workers to be laid off - but they help to develop among workers greater flexibility and a better sense of the need to keep their companies competitive. In fact, the co-operative relationships and trust are themes which underlie many stakeholding models with their emphasis on industrial partnership (Parkinson, 1996). Tomorrow's Company report also stresses the need to move away from an adversarial 'us' and 'them' business culture toward one of 'reciprocal relationships' and 'shared ambitions.' Therefore, the interest of the company' directors is to be essentially a long-term interest in the productive assets of an organisation, including the skills of its labour force, particularly those of its core workers, while the interest of the shareholders is a money capital interest in revenue and in the fictitious capital value of the share, an interest which is potentially short-term and transient. Thus, Tomorrow's Company report arguing that many CEOs mistakenly believe that their legal duty is to their current shareholders when, in fact, their duties are owed to 'the company, not to any specific third party group' (Royal Society of Arts, 1995). As fiduciaries, they must have regard to the interest of shareholders, but that obligation is not related to the holders of shares at one particular time, it is related to the general body of shareholders from time to time. The need is for directors to arrive at a balanced judgement about maximising the company's value on a sustainable basis, and not necessarily to take a short-term view of maximising returns for current shareholders.

The above discussion, therefore, explains the role of managers in the stakeholding company by stressing on the need for managers to switch their attention away from pleasing the current body of shareholders, which might for example lead to pressure to cut development expenditure to meet immediate profit targets, and to redirect it towards the strategic, long-term health of their companies (Day and Nedungadi, 1994). Therefore, one of the concepts that animates the report is that of 'sustainable success,' in which people and relationships are more than ever the key.

In this sense, the literature of corporate governance provides an alternative financial governance structure in line with the above co-operatives. This alternative is what is so-called third-party financier, which is common in the Japanese style of corporate governance (Flath, 1996). This alternative means that an institutional investor have a blockholding in two related companies: one company provides supplies to the other company (i.e., customer-supplier relationship). In this alternative arrangement, the third-party financier is supposed to co-ordinate relationships between the customer company and the supplier company to the extent that results in low co-ordination costs which might have been incurred by each or both. In this regard, the financing institution may broker deals when disputes between customers and suppliers come up, and smooth relationship during normal times.

The point is that this pattern of co-ordination is apparently characterised as a "financial-based co-ordination," where suppliers of capital can have financial stakes by joining together in a Keiretsu -like structure.

Although this structure can be looked at from the viewpoint of "stakeholders theory," it is actually a part of this theory. The reason is that this structure is feasible only in the cases of industrial organisation where customers, who are commonly firms, can join with suppliers, who are commonly firms as well, in such ways that both can influence each other's decisions.

The complete picture of the stakeholders theory can be drawn by considering that suppliers of capital can also be small investors with small financial stakes in the firm. These small investors are much likely to be customers or suppliers or even the firm's employees (ESOPs are an example) who are all investing their money in. Therefore, these stakeholders are more influential since they are suppliers of capital, sources of revenues, and services providers as well.

3.4 Shareholder versus Stakeholder Systems: An International Comparison

The growing literature on inter-corporate relationships, control and governance such as Gerlach and Lincoln (1992), Jensen (1993), Kester (1993) and Gilson and Roe (1993) compare the legalistic, stock market-driven approaches of the United States and the United Kingdom, or Anglo-Saxon countries, with the more informal cross share holding system adopted in Japan and Germany. Legal contracts with ultimate redress to courts are fundamental to the operation of Anglo-Saxon business culture. It is extensively discussed in works such as that of Jensen and Meckling (1976). What the United States tradition treats as inefficient, especially collaboration among multiple groups, is the means of doing business in countries such as Japan and Germany. Such trust mediated relationships through major banks are the means by which external stakeholders exercise control over internal management. This "communitarian" approach is also evident in other continental European countries such as Holland, Belgium, and the Scandinavian countries (Gilson and Roe, 1993). As shown in works by Dobson (1990), Jones *et al.*, (1997), informal mechanisms based on trust, obligation and exchange of hostage collateral may be fundamental to the effective business environment in societies such as those of Germany and Japan. These two major systems are compared in the figure (3-2) below.

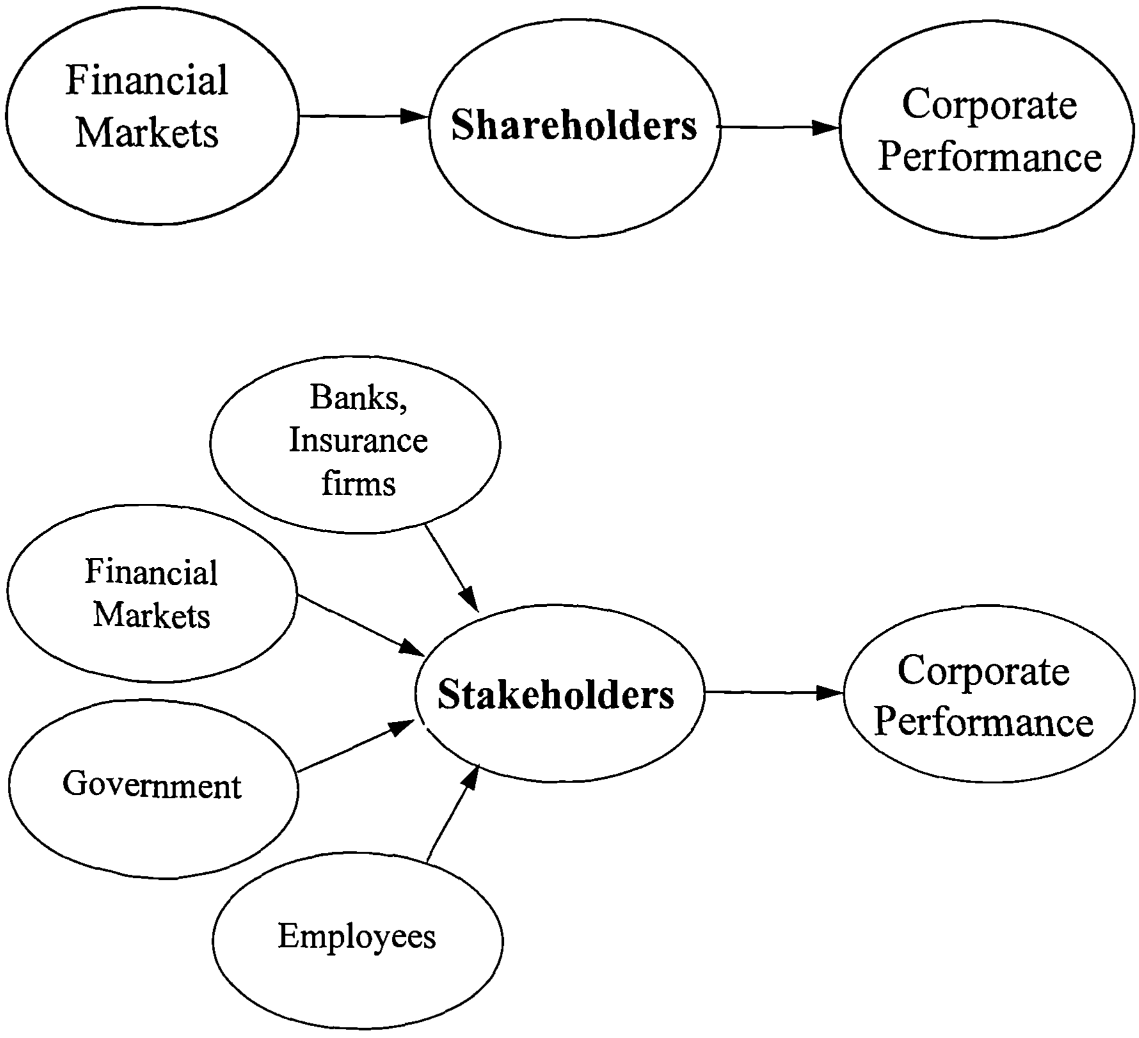

Figure (3-2): Shareholders versus Stakeholders Systems

Since the late 1980's, there has been an ongoing academic debate between the relative strengths of the shareholder and stock market-driven Anglo-Saxon countries such as the United States, United Kingdom versus the stakeholder and bank-driven countries such as Germany and Japan (Gilson and Roe, 1992; Kester, 1993). In order to better understand either the Japanese or German stakeholder system, there is a need for greater understanding of the institutuions, especially the "banks" that work with the private corporations in establishing a strong institutions network for the whole country.

3.5 Banking Governance: An International Perspective

The evolving governing role of financial intermediaries is indicated through a distinct body of literature that examines the screening and monitoring activities of debt holders. It has evolved separately because it is largely unconcerned with the self-interested behaviour of managers. Instead, it assumes that managers are perfect agents of their shareholders and focuses on the conflict between debt holders and equity holders. This literature explains lending through financial intermediaries as delegated monitoring: the intermediary pools money from investors, lends it, and monitors on their behalf (Diamond, 1984; Leland and Pyle, 1977; Scott, 1986). In addition, the benefits of the governing role of the intermediaries are indicated by considering that intermediation resolves the problems of free-riding and duplicative monitoring efforts. Moreover, the intermediary itself typically enjoys information-producing economies that make it a superior screening and monitoring agents (Leland and Pyle, 1977; Fama, 1985).

The role of the banks in particular as a delegated monitors for their depositors is well established in the literature (Benston and Smith, 1976; Black, 1975; Campbell, 1979; Campbell and Kracaw, 1980). For the United States, despite the relatively low range of roles that the American banks could play due to historical restrictions (Roe, 1997), the banks could play an influential role in monitoring and reacting to managerial slack (Triantis and Daniels, 1995; Booth, 1992). For example, the definition of debt covenants and events of default in lending agreement raise the likelihood that the lender exit is prompted by slack rather than lender opportunism and thereby enhances the information value of exit. As the presence of free cash facilitates managerial slack, the governing phase of the bank loans is emphasised when the lender is given either a security interest in assets of the borrower or some other form of priority rights: these features constrain the ability of managers to liquidate non-cash assets or to raise new funds by selling debt in the future. Therefore, in the United States the governing role of banks is supportive to the 'stakeholders management,' since the concerns about the managerial slack are shared to some degree by all parties who contribute to the enterprise. That is, interdependencies exist even across classes of stakeholders (Levmore, 1982; Adler, 1993, Stiglitz, 1985).

The benefits of banks governance are produced at several periods throughout the relationship between the lender and its borrower. First, the decision to lend signals to other stakeholders and potential stakeholders the quality of the borrower (Fama, 1985, 1990). Second, other stakeholders know that the imposition of fixed obligations under the loan agreement forces managers to avoid misusing free cash, thus reducing managerial slack in the form of managerial perks or empire building (Jensen, 1986; Buckley, 1992).

As the stakeholders approach permits interrelationships between and among stakeholders, then mutual benefits between and among them, Triantis and Daniels (1995) promulgate a theory of 'interactive corporate governance' based on the role of corporate banks debt as a mechanism that is able to support other stakeholders' interests. As they put it:

> "Under the theory of interactive corporate governance, this system of interstakeholder signals permits information gathered by dispersed stakeholders with concentrated expertise and heterogeneous perspectives on the firm's affairs to be communicated to those stakeholders best able to correct the managerial slack. It is this interaction among stakeholders who share governance responsibilities that distinguishes our theory from interdependent government theories that envision crisp delegations of responsibility." (Triantis and Daniels, 1995: 1081).

It is obvious that the theory of interactive corporate governance imply that the stakeholders benefit not only from the ability of banks to deter and detect managerial slack by monitoring, but also from the actions taken by banks following the detection of slack. A bank may respond by scaling down or terminating its relations with the borrower (exit). Alternatively, the bank may use its threat of exit to intervene in the decisions of the firm (voice) (Hirschmann, 1970; James, 1987; Lummer and McConnell, 1989).

At a more general level, the banking industry play a fundamental role in successful stakeholder systems. For example, the U.S. public corporations, which operate under a shareholder business system, are required by securities laws to disclose most instances of "exit" by a prominent lender (Block, 1985).

The banks' exit may send an early signal to other stakeholders that prompts them to act earlier than they might have otherwise in order to correct slack (Ofek, 1993). The gains from voice are a function of the ability to influence management and thereby improve firm performance. In exercising its "voice," the bank can draw on expertise and information acquired in the monitoring stage. In addition, it may hold sufficient debt to have an incentive to intervene on its own without facing the obstacles to collective action that impede the exercise of governance rights by other diffuse stakeholder groups. In particular, whereas dispersed shareholders may be unable to discipline management effectively through their voting rights, a bank with a large enough investment will have sufficient incentive to intervene effectively.

In addition, the U.S. legal arrangement assures bank's voice to be more influential despite the known bias of lenders in favour of conservative strategies that may not be value-maximising: the courts are prepared to permit the exercise of bank voice to influence firm decisions. In this regard, the exercise of bank voice prior to the firm's insolvency sends timely signals to other stakeholders who may then react to correct any slack. The bank may defer exit and use the threat of exit as a lever to intervene in the firm's decisions. The leverage confers considerable discretion on the bank in its exercise of voice (Triatis and Triantis, 1994). Moreover, the availability of Chapter 11 bankruptcy proceedings offers corporate management a way to forestall the collapse and correct its slack under the close scrutiny of its creditors and the bankruptcy courts (Triantis, 1996; LoPucki and Triantis, 1994; Triantis and Daniels, 1995). De Long (1991), For example, points to a significant governance role played by J. P. Morgan partners in the companies J. P. Morgan invested in the early 20^{th} century. More recently, U.S. banks played a major governance role in bankruptcies when they change managers and directors (Gilson, 1990).

In contrast, for stakeholder countries such as Japan, Kaplan and Minton (1994) and Kang and Shivdasani (1995) document the higher incidence of management turnover in response to poor performance in companies that have a principal banking relationship relative to companies that do not. In addition the Japanese main banks effectively monitor their debtors, helping to prevent business failure (Gilson and Roe, 1993). These benefits are a result of the Japanese system of corporate governance which is characterised by a complex network of inter-corporate equity holdings, with Japanese banks at the centre of the network (Morck and Nakamura, 1993). As a large number of commentators have observed, bank oversight replaces the market for corporate control in Japan (Sheard, 1989; Hoshi, *et al.*, 1990; Prowse, 1992; Kaplan and Minton, 1993; Aoki, *et al.*, 1994; Gilson and Roe, 1993; Morck and Nakamura, 1993). Alternatively, it is essential to ensure that the Japanese system of federal deposit insurance guarantees the incentive of financial institutions to monitor and influence corporate performance (Fruin, 1992; Lichtenberg and Pushner, 1994; Berglöf and Perotti, 1994).

For Germany, it is characterised by its distinct 'Universal Banks System,' which is the main focal point of German corporate governance (Gilson, and Kraakman, 1993). The German firms obtain most of their external financing from bank borrowing rather than capital markets: the German financial markets were suppressed for the benefit of big banks. Few individual owners of shares attend shareholders' annual meetings in Germany, even by proxy, except when their shares are deposited with big banks (Carney, 1997). As a result, these banks cast over 82 per cent of the votes at meetings of widely held corporations, and in most cases hold a majority of the shares present and voting. Because these banks generally hold over three-quarters of all shares present and voting, they have the power to amend articles of incorporation and bylaws. In addition, most corporations have bylaw provisions preventing any one shareholders from voting more than 5 per cent of the company's stock, with an exception of shares voted by banks in their capacity as custodians (Baums, 1992).

The effects of the universal banks on the German corporate performance is empirically evidenced in the literature. Cable (1985), for example, finds a significant, positive relationship between the degree of bank involvement in a firm and its financial performance. As a result, bank involvement supposedly improves the profitability of firms. Gorton and Schmid (1996) find evidence of banks improving company performance (to the extent they hold equity) more than other block holders do in 1974, although this is not so in 1985. Commentators argue that German banks have the position, information and power to effectively monitor the activity of management and, when necessary, to discipline management (Gilson, and Kraakman, 1993). In this regard, the most striking aspect of the AGs (the German *Aktiengesellschaft*: the corporate organisational form) is that fixed claimants, banks and employees, almost completely dominate the supervisory boards of these firms. Because German banks are heavily represented on the supervisory boards (Roe, 1993b) and the boards of companies with more than 2000 employees must have employee representation equal to that of the shareholders (Kübler, 1991), the combined power of the fixed claimants dominates the board.

Although banks account for only about 6 percent of large stakes in German firms, they tend to exert effective control over a majority of the shares voted in annual meetings. This is due to a prominent characteristic of the German corporate governance system: German banks vote bearer shares that they hold as custodians for small shareholder-clients of the banks brokerage operations (Macey and Miller, 1995). This distinct characteristic shows the ability of the German banks to consider and support corporate stakeholders' interests, including the interests of the shareholders themselves. Furthermore, Franks and Mayer (1992, 1997a,b) present an empirical evidence that bank ownership is of significant importance through proxy votes, voting right restrictions and board representation in the minority of widely held companies with no single shareholder in excess of 25 per cent.

As banking finance is quite substantial in Germany and Japan, the powers of the banks *vis-à-vis* companies are very significant because banks vote significant blocks of shares, sit on boards of directors, play a dominant role in lending and operate in a legal environment favourable to creditors. In Italy, even where procedures for turning control over to the banks are not well established, both macro-studies and micro-evidence show that Italian banks have played a central and crucial role in financing economic growth by assessing the credit-worthiness of borrowing firms (Barca, 1996).

The overall picture of banks governance in the Anglo-Saxon countries such as the United States and United Kingdom and Communitarian countries such as Germany and Japan shows that banks have been positively contributing to companies performance whether they invest in, or lend to, these companies. Whatever the degree of their involvement in corporate affairs, banks are able to monitor, and if necessary react to, corporate performance (Triantis and Daniels, 1995). In addition, banks can overcome the free rider problem in information gathering which afflicts lending by a large number of dispersed investors (Diamond, 1984). Recent studies suggest that there may be advantages to long-term relations between banks and firms: long-term relations improve banks' evaluations of the quality of firms (Mayer, 1988, 1997; Sharpe, 1990; Vonthadden, 1995). Therefore, the positive effects of banks' contribution on the economic growth in both of the Anglo-Saxon and the Communitarian business systems encourage to claim that banks are more capable of supporting the stakeholders' interests than the commonly known stock market mechanisms of corporate governance.

Most notably, the study of the stakeholders' interests are not, and should not be, an objective *per se*, rather it should incorporate these interests to corporate competitiveness. As monitoring corporate competitiveness requires institutional entities capable of producing and exploiting useful information about companies performance, banks can provide solid institutional governance that benefits other corporate stakeholders. In this regard, if the stock market is considered a qualified institution within which corporate governance mechanisms provide tangible measure of corporate performance, banks can provide an institutional certification capable of producing and monitoring both of tangible and intangible measures of corporate performance.

3.6 Banks-Corporate Stakeholders Orientation, Governance, and Performance: An Empirical Evidence

3.6.1 Sample Consistency

As the two groups chosen in this study (the Corporate Loans Managers and the Finance Directors) represent two point of views regarding the role of creditors and the role of shareholders in the issues of corporate stakeholders, an ANOVA analysis is carried out to show the significance of the two point of views. To determine the extent of consistency between the two samples, a simple factorial ANOVA is carried out for both of the two groups of the study under the following assumption:

$$H_0 : \mu_1 = \mu_2$$
$$H_1 : \mu_1 \neq \mu_2$$

Where μ_1 = mean of the first sample (Corporate Loans Managers).
μ_2 = mean of the second sample (Finance Directors).

Table (3-1) shows summary of the results of the simple factorial analysis for each of the dependent variables. As the simple factorial analysis requires dependent variables (Ys), the researcher uses the banks performance measures included in POLK World Banking Profiles (1996).[1]

[1]. To avoid any source of bias when selecting any of the numerous measures of banks performance, a correlation matrix was carried out between the dependent variables. The dependent variables used in the simple factorial analysis are not those highly correlated with

Table (3-1): Summary of simple factorial ANOVA[2]

Variables	Y1	Y5	Y6	Y8	Y10	Y11	Y12	Y13
p-value	0.917	0.459	0.515	0.735	0.458	0.368	0.581	0.435

The results of the simple factorial ANOVA show that *p*-value > 0.05 which means that the difference between the two samples is not significant.

3.6.2 Data Normality

The data normality is tested by carrying out χ^2 test. The results are shown in table (3-2).

Table (3-2): The statistical results of χ^2 test of the variables of banks' stakeholders orientation[3]

Variables	*p*-value	Variables	*p*-value
Employees' contribution	0.061	Unions-relationship development	0.057
The effects of the suppliers	0.078	Suppliers-relationship development	0.071
Customers' contribution	0.058	Interests of community	0.041
Creditors' contribution	0.053	The role of the employees	0.056
Shareholders' contribution	0.081	The role of the managers	0.054
Managers' contribution	0.043	The role of the suppliers	0.064
Community's contribution	0.071	The effects of the shareholders	0.044
Unions' contribution	0.058	The role of the industrial unions	0.081
Customers satisfaction	0.092	Governmental-relations development	0.073
Employees development	0.032	Stakeholders-oriented policies	0.055

Table (3-2) shows that four out of the twenty variables used in the study are not normally distributed (*p*-value < 0.05). That is, 80 per cent of data are relatively normally distributed.

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each other (in general, the correlation coefficients that are less than 0.50 are chosen). The correlation matrix is included in the Appendix (3-1).

[2] Y1 = Net Interest Income/Total Revenue; Y5 = Liquid Assets/Deposits & Borrowings; Y6 = Non-Performing Loans/Total Loans; Y8 = Provisions/Gross Loans; Y10 = Capital Funds/Total Assets; Y11 = Return on Investment; Y12 = World Ranking (According to Return on Assets), Y13 = Country Ranking (According to Return on Assets).

[3] The χ^2 test is carried out at the significance level 95%.

3.6.3 Data Validity

3.6.3.1 *Content and construct validity*

As for the content validity, after completing the questionnaire, it was sent by mail to randomly selected 9 banks (which represent around 10 per cent of the population of the study). The respondents were asked about the validity of the measures for addressing the variables, ambiguity and difficulty in responding. Six of those piloting banks replied and the questionnaire was modified accordingly.

As for the construct validity, the variables used in the study have basically been examined separately in other related studies in the literature of corporate social responsibility, corporate social performance and stakeholder management. In fact, there is an agreement between the scholars who examined those variables on the operational definition of those variables. Therefore, this provides an adequate evidence for construct validity.

3.6.3.2 *Discriminant validity*

A single-factor test was performed on the data in order to test for discriminant validity (Podsakoff, and Organ, 1986). In order to provide a multivariate perspective on the 20 variables included in the study, a Principal Components Factor Analysis with varimax rotation is carried out. The decision to include a variable in a factor was based on factor loadings greater than 0.50 and all factors whose eigenvalue was greater than one were retained in the factor solution. (Tabachnick and Fidell, 1989; Hair *et al.*, 1995). This analysis yielded a five factor solution which accounts for 77.9 per cent of explained variance. Table (3-3) shows a summary of the results of the Principal

Component Factor Analysis. The loading solution resulted in virtually unique significant factor loading as the resulted factors represent a principal issues addressed in the literature of corporate governance and corporate stakeholders. Therefore, the analysis provides evidence of discrimination between those issues on the part of the respondents, and suggests that common method variance is not problematic. This result is particularly important in validating the respondents' perceptive ability to differentiate between the issues raised in the questionnaire.

Table (3-3): Results of single-factor test for discriminant validity

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5
Employees' contribution			0.80		
The effects of the suppliers					0.72
Customers' contribution			0.76		
Creditors' contribution				0.62	
Shareholders' contribution				0.71	
Managers' contribution			0.64		
Community's contribution			0.88		
Unions' contribution			0.68		
Customers satisfaction			0.51		
Employees development			0.82		
Unions-relationship development		0.86			
Suppliers-relationship development		0.89			
Interests of the community			0.54		
The role of the employees	0.90				
The role of the managers	0.95				
The role of the suppliers	0.97				
The effects of the shareholders					0.96
The role of the industrial unions	0.58				
Governmental-relations development		0.94			
Stakeholders-oriented policies	0.55				
Eigenvalue	6.97	3.21	2.49	1.64	1.26
Percentage of Variance	34.9	16.0	12.4	8.2	6.3
Reliability Analysis					
alpha	0.81	0.76	0.82	0.74	0.71
F-Ratio	21.36*	14.19*	94.05*	4.13**	4.32**

* Significant at the significance level 99%.

** Significant at the significance level 95%.

3.6.4 Data Reliability

The reliability of the variables retained in each factor is tested by carrying out a Reliability Analysis (*alpha*). The results of the Reliability Analysis are shown in table (3-3). The coefficient greater than or equal to 0.70 are considered acceptable and a good indication of construct reliability (Churchill, 1979; Nunnally, 1978).

3.6.5 Empirical Results

As the χ^2 test indicates that the data is relatively normally distributed, the parametric one-way ANOVA analysis is carried out to assess the relative role the banks can play to support corporate stakeholder orientation. The ANOVA analysis is carried out to each of the five factors resulted from the Principal Component Analysis.

Factor 1: The relative role of stakeholders in corporate decisions

The one-way ANOVA is carried out under the following hypothesis:

$$H_0 : \mu_1 = \mu_2 = \ldots\ldots = \mu_5$$

$$H_1 : \text{ not all } \mu_j \text{ are equal } (_j = 1,\ldots,5)$$

Where: $\mu_1,\ldots,\mu_5$ = means of the Employees' role, Managers' role, Suppliers' role, Industrial unions' role, and Stakeholders' role respectively.

Table (3-4) shows the extent to which the Corporate Loans Managers, as representatives of corporate creditors, and the Finance Directors, as representatives of corporate shareholders' orientation, support the idea of getting corporate constituencies involved in, or at least sharing in, making corporate decisions.

Table (3-4): ANOVA analysis of the relative role of each of corporate stakeholders in making business and /or managerial decisions

Groups of the study	**Corporate Loans Managers (Commercial Banks)**				**Finance Directors (Investment Banks)**			
Variables	Mean	F Ratio	*Levene statistic*[4]	*TUKEY HSD*[5]	Mean	F Ratio	*Levene statistic*	*TUKEY HSD*
Employees' role	0.26	50.3*	50.1*		3.50	26.4*	39.2*	*differ*2
Managers' role	0.84			*differ*	3.00			*differ*2
Suppliers' role	0.08				1.86			*differ*1
Industrial unions' role	0.22				0.86			
Stakeholders -oriented policies	2.53			*differ*	1.95			*differ*1

* Significant at the significance level 99%.

As for the Corporate Loans Managers, the differences between the numerical values that represent corporate constituencies' role in decision making are statistically significant. This means that the Corporate Loans Managers see some differences in corporate constituencies' role in decision making. This conclusion is supported by the result of the *TUKEY-HSD* test where it shows significant difference between managers' role, stakeholders-oriented policies, and the rest of corporate constituencies. Specifically, managers' role and stakeholder-oriented policies are recognised in one group and, therefore, do not differ from each other. This supports the idea that corporate orientations toward its stakeholders interests depends upon the role managers can play as active agents in the process of corporate decision making.

[4] Levene test is a measure for the Homogeneity of Variance.

[5] The *TUKEY-HSD* (Honestly Significant Difference) is a multiple range test which is used to compare each pair of groups to see whether the difference between them is significant at the significance level 95%. The notion *'differ'* refers to a significant difference, and the associated number refers to whether the certain group is similar to another group.

In contrast to the Corporate Loans Managers, the Finance Directors differentiate between corporate constituencies' role in the process of decision making. In addition, the differences between the numerical values that represent corporate constituencies' role are statistically significant. *TUKEY-HSD* test shows significant differences between the role of corporate constituencies. Specifically, the role of both of corporate managers employees does not differ significantly and, therefore, is grouped in one group, while the role of corporate suppliers and stakeholders-oriented policies is grouped in a separate group. It is clear that the managerial phase of corporate decision making is different from corporate external orientation which is represented by both of the suppliers and the stakeholders-oriented policies.

Factor 2: *External relationship development*

The one-way ANOVA is carried out under the following hypothesis:

$$H_0 : \mu_1 = \mu_2 = \ldots\ldots = \mu_3$$
$$H_1 : \text{ not all } \mu_j \text{ are equal } (j = 1,\ldots,3)$$

Where: $\mu_1,\ldots,\mu_3$ = mean of *Unions-relationship development*, *Suppliers-relations development*, and Governmental-relations development respectively.

Table (3-5) shows the importance of building strong relationships with number of corporate external stakeholders: the unions, suppliers, and governmental relationships respectively.

Table (3-5): ANOVA analysis of the external relationship development

Groups of the study	Unions-relations development	Suppliers-relations development	Governmental-relations development
Corporate Loans Managers (Commercial Banks)			
Mean	1.92	2.00	0.20
F-Ratio *Levene test* statistic		876.41 * 6.09 *	
TUKEY-HSD test	*differ*	*differ*	
Finance Directors (Investment Banks)			
Mean	1.81	1.83	2.38
F-Ratio *Levene test* statistic		8.83 * 8.97 *	
TUKEY-HSD test			*differ*

* Significant at the significance level 99%.

The results show that the Corporate Loans Managers consider both of unions' and suppliers' relations development of equal importance since the two groups do not differ significantly from each other and, therefore, is grouped in one group. It seems that the governmental relations development is left out because, according to the theory of political institutions, banks are not the institutions that can interface and/or intermediate between companies and governments. Political and legal entities in the society are responsible for institutionalising those relationships. This conclusion does not apply to the finance Directors where they consider only the governmental-relations development quite different from those of unions and suppliers. This result reflects the shareholders' concern about any governmental regulations that may affect the private investment in the society and, therefore, affect the returns on the stocks they are investing their money in.

Factor 3: The orientation towards Stakeholders Management

The one-way ANOVA is carried out under the following hypothesis:

$$H_0: \mu_1 = \mu_2 = \ldots\ldots = \mu_8$$
$$H_1: \text{ not all } \mu_j \text{ are equal } (_j = 1,\ldots,8)$$

Where: $\mu_1,\ldots,\mu_8 =$ means of Employees' contribution, Customers' contribution, Managers' contribution, Community's contribution, Unions' contribution, Customer satisfaction, Employees development, and Interests of community respectively.

Table (3-6) presents an aggregate view of both of the two groups of the study regarding a number of the basic components of 'stakeholder management.' The table includes the respondents' opinions about the extent of corporate managers' orientation towards the importance of eight of the basic components of 'stakeholders management': the employees' contribution, the customers' contribution, managers' contribution, community's contribution, unions' contribution, customers satisfaction, employees development and taking interests of the community into account respectively.

Table (3-6): ANOVA analysis of the orientation towards 'Stakeholders Management'

Groups of the study	**Corporate Loans Managers (Commercial Banks)**				**Finance Directors (Investment Banks)**			
Variables	Mean	F Ratio	*Levene statistic*	*TUKEY HSD*	Mean	F Ratio	*Levene statistic*	*TUKEY HSD*
Employee's contribution	3.60			*differ*3	3.50			*differ*3
Customers' contribution	2.88			*differ*2	3.00			*differ*3
Managers' contribution	2.90			*differ*2	3.10			*differ*3
Community's contribution	1.15				1.04			
Unions' contribution	1.65	42.1*	10.7*		0.86	64.7*	13.5*	
Customers' satisfaction	1.50				1.81			*differ*2
Employees development	1.51				1.53			*differ*1
Interests of Community	2.15			*differ*1	1.36			*differ*2

* Significant at the significance level 99%.

As for the Corporate Loans Managers, the results show that the differences between the numerical values of the eight components are statistically significant, which means that there are some differences between the eight components. Specifically, interests of community is recognised in one group, both of customers and managers contribution is recognised in different group, and finally employees contribution is recognised in separate group. These results show that a close relationship exists between customers and managers contribution which means that managers orientations, as internal constituencies, are directed to customer orientations as external constituencies. Therefore, the close internal and external relationships is considered a basic component of the 'Stakeholders Management.'

Since community's contribution, unions, contribution, customers satisfaction, and interests of community are considered of relatively importance, these four components present an additional evidence that shows the close relationship between corporate external and internal orientations. That is, employees development is one of the internal components of the stakeholders management, while the other three are three components of the stakeholders management. The conclusion is that the Corporate Loans Managers clearly recognise the basic components of the stakeholders management.

The results of the Finance Directors show a different perspective. The differences between the numerical values of the eight components are statistically significant which means that they are some differences between them. Specifically, the Finance Directors recognise employees contribution, customers' contribution, and managers contribution in one group, customers satisfaction and interests of community in another group, and employees development in a different group. As long as both of employees, customers and managers contribution is grouped in one group, this shows a clear recognition of one of the basic components of stakeholders management. Another component is the orientation towards corporate external relationship which is represented by customers satisfaction and interests of community as one group. The conclusion is relatively the same as the one of the Corporate Loans Managers where the Finance Directors recognise clearly the basic components of the stakeholders management.

Factor 4: The financial phase of corporate governance

The one-way ANOVA is carried out under the following hypothesis:

$$H_0 : \mu_1 = \mu_2$$
$$H_1 : \mu_1 \neq \mu_2$$

Where: μ_1 = mean of the first sample (Creditors' contribution).
μ_2 = mean of the second sample (Shareholders' contribution).

Table (3-7) shows both of the Corporate Loans Managers' and the Finance Directors' opinions toward what can corporate creditors and corporate shareholders contribute to keep their company functioning well.

Table (3-7): ANOVA analysis of the financial phase of corporate governance

Groups of the study	Creditors' contribution	Shareholders' contribution
Corporate Loans Managers **(Commercial Banks)**		
Mean	2.38	1.42
F-Ratio *Levene test* statistic	13.50 * 49.29 *	
Finance Directors **(Investment Banks)**		
Mean	1.50	1.68
F-Ratio *Levene test* statistic	0.44 2.00	

* Significant at the significance level 99%.

As for the Corporate Loans Managers, they do not see both of these constituencies' contributions of equal importance, where the difference between the numerical values of both of them is statistically significant. As for the Finance Directors, they see both of these constituencies' contributions of equal importance to keep a company functioning well. The difference between both of the two groups of the study has its roots in the role of debt versus equity in the literature of corporate governance. The Corporate Loans Managers, as representatives of corporate creditors, favour a dominant role of debt on the process of corporate governance, while the Finance directors, as representatives of shareholders' orientation, favour relatively equal contributions from both of corporate creditors and shareholders, then recognising the fact that in most cases the dispersed, ill-informed shareholders would not have a dominant role in the process of corporate governance. Thus, this process requires both of corporate creditors' and shareholders' contributions. This result is well evidenced in the literature of corporate governance mechanisms.

Factor 5: External effects on corporate operations

The one-way ANOVA is carried out under the following hypothesis:

$$H_0 : \mu_1 = \mu_2$$
$$H_1 : \mu_1 \neq \mu_2$$

Where: μ_1 = mean of the first sample (Supplier's effects).
μ_2 = mean of the second sample (Shareholders' effects).

Table (3-8) shows both of corporate suppliers' and shareholders' effect on corporate operations.

Table (3-8): ANOVA analysis of the external effects on corporate operations

Groups of the study	Suppliers' effects	shareholders' effects
Corporate Loans Managers (Commercial Banks)		
Mean	1.15	0.22
F-Ratio	141.81*	
Levene test statistic	6.79*	
Finance Directors (Investment Banks)		
Mean	1.86	2.18
F-Ratio	9.79*	
Levene test statistic	17.79*	

* Significant at the significance level 99%.

As for the Corporate Loans Managers, the differences between the numerical values of both of the suppliers and shareholders are statistically significant which means that they are not of equal importance. This is the same as the result of the Finance Directors.

Banks-Corporate Stakeholders Orientations and Banks Performance

This section focuses on whether banks are in a position to support the 'Stakeholders Management.' In this regard, the banks-corporate stakeholders orientations are regressed against banks performance measures. To reach an acceptable conformity about the banks performance measures, the researcher uses those measures published by POLK World Banking Profiles (1996). A Principal Component Factor Analysis (varimax rotation) is carried out for the banks performance measures as more than one measure are measuring the performance dimension. These measures, therefore, are minimised to the most basic (principal) measures. The results of the Principal Component Factor Analysis are shown in table (3-9).

Table (3-9): Results of Principal Components Factor Analysis of banks' performance measures

Variables	**Factor 1**	**Factor 2**	**Factor 3**	**Factor 4**
Net Interest Income/Total Revenue		0.52		
Operating Income/Total Assets	0.95			
Liquid Assets/Total Assets		0.93		
Liquid Assets/Total Deposits		0.94		
Liquid Assets / Deposits & Borrowings		0.98		
Non-Performing Loans/Total Loans			0.91	
Reserves/Gross Loans			0.92	
Provisions/Gross Loans			0.76	
Shareholders Equity/Total Assets				0.96
Capital Funds/Total Assets				0.97
ROI	0.96			
World Ranking	0.94			
Country Ranking	0.95			
Eigenvalue	4.50	2.82	2.53	1.55
Percentage of Variance	34.6	21.6	19.5	11.9
Reliability Analysis				
alpha	0.94	0.96	0.77	0.98
F-Ratio	42.41*	38.2*	25.77*	70.38*

* Significant at the significance level 99%.

Table (3-9) shows the results of the Principal Components Analysis of banks' performance measures. The table shows that those measures are classified to four principal factors (e.g., groups). They are as follows.

- **Factor 1: Profitability Measures**: which comprise the Operating Income/Total Assets, Return on Investment (ROI), World ranking (according to Return on Assets), and Country ranking (according to Return on Assets).

- **Factor 2: Liquidity Position**: which comprises the Net Interest Income/Total Revenue, Liquid Assets/Total Assets, Liquid Assets/Total Deposits, and Liquid Assets/Deposits & Borrowings.
- **Factor 3: Assets Quality**: which comprises the Non-performing Loans /Total Loans, Reserves/Gross Loans, and Provisions/Gross Loans.
- **Factor 4: Capital Adequacy**: which comprises the Shareholders Equity/Total Assets and Capital Funds/Total Assets.

Table (3-9) shows also the results of the Reliability Analysis of the performance measures retained in each factor. The high *alpha* coefficients indicate a good construct reliability, and the coefficients are all statistically significant at the significance level 99%. The four banks' principal performance measures are stepwise regressed against the five principal factors of banks-corporate stakeholder orientations presented in table (3-3). The results are shown in table (3-10) which shows the results of the Stepwise Regression Analysis. The results indicate a very logic and practical perspectives in the relationship between banks-stakeholding orientations and their performance measures.

Table (3-10): Results of Stepwise Regression between banks performance measures and their stakeholding orientation [1]

Banks-Corporate stakeholders orientation	**Profitability Measures**	**Liquidity Position**	**Capital Adequacy**	**Asset Quality**
Constant	0.11 (1.33)	0.08 (1.44)	-0.003 (-0.04)	0.17 (1.21)
The Relative role of stakeholders in making corporate decisions				
External relationship development	0.56 (2.27)**			
The orientation towards 'Stakeholders Management'			0.47 (2.71)*	0.34 (2.44)*
The financial phase of corporate governance		1.32 (4.94)*		
External effects on corporate operations				
Adjusted R^2	0.18	0.55	0.25	0.31
F-Ratio	5.18**	24.49*	7.35*	6.81*
VIF	1.00	1.00	1.00	1.00
D-W statistic	1.67	1.75	1.81	1.74
N	20	20	20	20

1 t-statistics are given in parentheses.

* Estimates are significant at the significance level 99%.

** Estimates are significant at the significance level 95%.

An autocorrelation test is carried out using D-W (Durbin-Watson) test (Koutsoyiannis, 1977; Gujarati, 1992; Greene, 1997) under the following two hypothesises:

$$H_0 : \rho = 0 \text{ (the } u\text{'s are not autocorrelated)}$$
$$H_1 : \rho \neq 0 \text{ (the } u\text{'s are serially dependent)}$$

where ρ = the coefficient of the autocorrelation relationship.

The results of the autocorrelation analysis show that the null hypothesis is accepted since the observed values of the Durbin-Watson test

(d^*) are greater than d_u (with n - k degree of freedom and significance level $p < 0.01$). Therefore, the four regression equations are free from autocorrelation among u's.

As for the multicollinearity, it is carried out using the VIF (Variance Inflationary Factor) test under the following two hypothesises:

$$H_0 : \text{the X's are orthogonal}$$
$$H_1 : \text{the X's are not orthogonal}$$

where X's = Factors of banks-corporate stakeholders orientation.

The results of the VIF test show that the X's are not multicollinear where the scores of the VIF test are equal, or very close, to 1.00 [the correlation matrixes of the explanatory variables are listed in Appendixes (3-3) - (3-6)].

The results show that the correlation between the external relationship development, represented by unions, suppliers and governmental relationships, and profitability measures is supported by the literature on the importance of corporate strong ties and corporate communications and their effects on corporate performance (Granovetter, 1973, 1985; Burt, 1982; 1992a, b; Burt and Talmud, 1993; Podolny, 1993). The financial phase of corporate governance, represented by creditors'and shareholders' contribution is correlated with measures of liquidity position. This result is supported by the numerous findings on the literature of corporate governance that the principal corporate financiers are keen to make sure that the company they are investing their money with is managed efficiently and, therefore, is capable of meeting its financial obligations in due times (Grier and Zychowicz, 1994; Triantis and Daniels, 1995; Hart and Moore, 1995; Shleifer and Vishny, 1997).

The orientation towards 'Stakeholders Management' is correlated with measures of capital adequacy. Once again, this result is supported by the empirical findings on the literature of the importance of corporate indices as good indicators of corporate orientations. That is, corporate orientation towards its stakeholders interests provides good indices to encourage its stakeholders to support the company's plans, including raising the needed capital (Preston and Post, 1975; Sethi, 1975; Fleming, 1981; Wartick and Cochran, 1985; Wood, 1991a; Clarkson, 1995). The orientation towards 'Stakeholders Management,' is also correlated with measures of asset quality. This result is supported by the literature on corporate stakeholders that describes the importance of their relative contributions to keep a company functioning well (Clarkson *et al.*, 1992; Reichheld, 1996). That is, the governing role of managers and employees is realised as they are practically responsible for conducting and improving corporate assets, customers contribution and satisfaction is one of the major factors that determine the company's relative competitiveness in the market place, and finally, if a company is not neglecting the interests of the community, it would be able to improve its asset quality.

In sum, Table (3-10) shows that the *Adjusted* R^2 of the four performance measures are acceptable. This result is supported by the results in Table (3-3) where three out of the five factors of banks-corporate stakeholders orientations affect the basic banks four performance measures. This means that if banks support corporate stakeholders orientations, their (banks) performance would be affected positively. These results extend Cornell and Shapiro's pioneering idea of incorporating stakeholders interests into corporate finance (Cornell and Shapiro, 1987). That is, corporate stakeholders' interests and capabilities can be considered as financial assets and liabilities.

3.7 Conclusions

The role of stakeholder frameworks in the success of business and society has recently become a crucial area of academic research. The purpose of this chapter was twofold. Firstly, the researcher followed a qualitative comparison of successful shareholders systems such as the United States and United Kingdom, with successful stakeholder systems such as Japan, Germany, and most of continental Europe. It is an important factor that the concept of shareholder versus stakeholder systems can have wide applicability throughout the world, for example, Japan has similarities to countries in Western Europe. Secondly, the researcher focused on the banking industry which plays a crucial role in the success of stakeholder systems in Japan, Germany and most continental European countries. Through empirical analysis the researcher shows the compatible role of banking in successful shareholders and stakeholder systems.

The scope and analysis of this chapter was not to conclude, through international comparisons, general superiority of either shareholder systems in countries such as the United States and United Kingdom or stakeholder systems in countries such as Germany and Japan. The purpose of this chapter was to show the close compatibility between relatively strong banking industry and the values of stakeholder systems. In this sense, the value of the stakeholders can be realised when a firm conceives the fact that its competitiveness is related to collective appreciation and identification from its stakeholders rather than from only its shareholders. Here, it can be concluded that the interests of stakeholders are major factors that determine corporate identity in the market place as a non-financial aspect of corporate governance. This is what the next chapter discusses in details.

Chapter 4

Corporate Identity, Performance and Competitiveness: Empirical Evidence from the Banking Industry

4.1 Introduction

Chapter three has shown that banks as a viable financial institutions can act as good monitors to corporate stakeholders orientation. Furthermore, banks may benefit from their support to stakeholders interests. This chapter extends corporate orientations toward stakeholders interests to further examine their role in identifying corporate capabilities, thus its identity in the marketplace. This chapter examines the idea of corporate identity in the banking industry on the basis that product intangibility necessitates product identification to be done by more than one actor in the marketplace.

4.2 Dynamic Capabilities and Strategic Group Identity

The work in strategic group identity (Peteraf and Shanley, 1997) provides a useful framework on how different groups recognise each other dynamically. Peteraf and Shanley focus on the group characteristics as the distinguishing factors of group identity. As they define it:

> " A **strategic group identity** is a set of mutual understandings, among members of a cognitive intraindustry group, regarding the central, enduring, and distinctive characteristic of the group." (Peteraf and Shanley, 1997: 166).

This definition parallels what is provided in the work of organisation identity by Albert and Whetten (1985). Peteraf and Shanley's definition highlights two important cognitive factors: mutual understanding and common understanding among group members that a group of some sort exists. In this sense, the definition is consistent with the general principles governing cognitive categorisation (Rosch, 1978) and importance of groupings based on relative rather than absolute identity factors (Frank, 1988). Traditional identity factors include gender, age, ethnic background, income level.

According to Albert and Whetten (1985) and Peteraf and Shanley (1997) the *mutual understanding* must be in regard to the central characteristics of the group. The central characteristics may take the form of family traits, or a set of core relationships or activities. Central traits include observable features such as firm size, as well as nonobservable (intangible) features such as product quality. Core relationships and activities include features such as overlapping social networks and common institutional histories.

The researcher believes that the strategic group identity framework develops further the ongoing academic debate about the strengths of more economics-based frameworks of competition such as transaction cost economics (Williamson, 1975) and the more institutional and social structure-based approaches to competition (Granovetter, 1985; Simon, 1991; Burt, 1992a; Barney and Hansen, 1994; North, 1996). Recent empirical research such as Masten *et al.*, (1991) and Monteverde (1995) show that activities may be internalised within organisations, not because of the high transaction costs in the market, but because there are various unique benefits created within organisations such as lower communication costs. Related research by Holmstrom and Milgrom (1994) also show that organisations can also help to overcome the complexity of multitask activities, and where the costs of measurement are high, these effects are not necessarily linked to the transaction costs of carrying them out in the market. Their works also confirm the empirical analysis of Anderson and Schmittlein (1984) and Anderson (1985) which show that the difficulties of measurement of performance, and the importance of nonselling activities, such as helping other agents in the organisation were the crucial determinants of whether an activity was carried out within the organisation, or in the market. Again, the reasons for internalisation were not necessarily driven by the level of transaction costs in the market.

Furthermore, the strategic group identity framework raises the importance of intangibility and measurement costs within industries. Recent works in the institutional aspects of competition such as North (1996), Kogut and Zander (1996), Hill (1990), Ring and Van de Ven (1994) show the importance of the social structure and the social embeddedness of market transactions (Burt, 1992a,b; Barzel, 1982; Granovetter, 1985) which help to influence such measurement and reduce intangibility. The purpose of this chapter is twofold. Firstly, the researcher analyses the general issue of intangibility and measurement costs, and how organisations may respond to such problems. The researcher shows that "indices" or truthful signals may become important indicators for certain organisations to prove their value and strengths under problems of measurement and intangibility. These indices then provide additional "identity" measures to the traditional signals and other indicators used to evaluate organisations by the market. The strategic formation of such indices may be crucial for greater competitive success, adding a component of dynamics to the existing frameworks of analysis. Secondly, the researcher applies this framework to the banking industry where such intangibility and measurement costs exist. The researcher empirically tests this framework to show the importance of such indices in influencing strategic group identity and, in turn, the nature of competition when there are measurement costs and intangibility. By so doing, the researcher takes further the ongoing academic debate between the importance of the pure economics-based market competition, and the more institutional and social structure-based type of competition.

Teece *et al.*(1997) provide a framework of dynamic capabilities that outline the role of strategic management. They define dynamic capabilities as:

> "...the firm's ability to integrate, build, and reconfigure internal and external competencies to address rapidly changing environments." (Teece *et al.*, 1997: 516).

The cornerstones of the above definition are the firm's resources and competences. According to Teece *et al.* (1997), resources are firm-specific assets that are difficult, if not impossible, to imitate. When firm-specific assets are assembled in integrated cluster spanning individuals and groups so that they enable distinctive activities to be performed, those activities constitute firm's competences. In this regard, one aspect of the strategic problem facing an innovating firm in a world of Schumpeterian competition is to identify difficult-to-imitate internal and external competences most likely to support valuable products and services.

The dynamic capabilities approach, therefore, seeks to provide a coherent framework which can both integrate existing conceptual and empirical knowledge, and facilitate prescription. In so doing, it builds upon the theoretical foundations provided by Schumpeter (1934), Penrose (1995), Williamson (1975, 1985), Barney (1986), Nelson and Winter (1982), Teece (1988) and Teece and Pisano (1994). Firms in the financial services industries provide a good example of firms characterised by hard-to-imitate firm-specific resources. These firms' relatively important resources are the intangible resources that constitute the firm's portfolio of difficult-to-trade knowledge assets. The difficulty-to-trade raises an important dimension in the mechanisms of resources exchange: firm's resources and value will be affected by other's recognition concerning the firm's value. To develop and strengthen other's recognition, it requires how to convey and prove firm's identity to others and to the general market.

As for the enduring aspects of group identity, Peteraf and Shanley (1997) mean that there must be some degree of temporal stability or perceived continuity to the group and its central traits. Enduring characteristics may be the product of long-lived (sunk) capital investments or path-dependent research strategies. The distinctive characteristics of group identity allow members to distinguish between the group and other categories. They also permit observers to distinguish between core and peripheral members of the group. Distinctiveness has to do with how group characteristics are different from those of other groups. It is supported by mobility barriers which impede entry into the group by outsiders (Caves and Porter, 1977; Porter, 1980, 1985). In sum, the continuity aspect of strategic group identity implies a dynamic capability.

4.3 Strategic Group Identity and Indices

Strategic group identity enables mutual recognition between and among groups. This mutuality, thus, requires continuous and strong communications and references between and among groups. In this regard, the group's central characteristics are used as indices of the group identity, which imply an informational link between and among groups, thus determine the relative position of each group in the marketplace. In this sense, indices determine the extent and the scope of competition between groups that lead to what is called "disProportionate Competition" (Choi and Baden-Fuller, 1995).

In order to better understand such a framework, it is important to make the distinction between market signals and "indices." Market signals (Schelling, 1969; Spence, 1973) help communication and identification under uncertainty. Milgrom and Roberts provide a definition of signals:

> "...signals demonstrate to others the actor's intentions or abilities or some other characteristic about which the actor has private, unverifiable information." (Milgrom and Roberts, 1992: 154).

An example of a signal would be a firm's willingness to provide a money back guarantee for its products, to signal to consumers the firm's commitment and confidence in the product.

There are at least two potential problems of signals, in determining firms' identities in the market for industries such as financial services, which have a high element of intangibility in the value of their products and services. Firstly, a particular firm's network in the search for a co-operative exchange partner, such as a strategic group, may be screening according to certain path-dependent, homogeneous beliefs, and cognitive maps of reality which may not be an accurate measure of reality. As analysed by Burt (1992a,b) and Burt and Talmud (1993), certain networks may become so dense that they may actually hold back the dissemination of important changes in reality that have occurred outside the network. Related to this issue is the analysis of Granovetter (1973, 1985), Oliver *et al.*, (1985), Oliver and Marwell (1988) and Marwell, *et al.*, (1988) concerning the importance of certain weak ties, or relatively less homogeneous relationships, in developing objective views of the external environment and judging the capabilities and assets of a potential co-operative exchange partner. Secondly, signals can be manipulated by actors for strategic ends. In an increasingly media dependent world with decreasing communication costs, there is a plethora of signals from numerous actors in the society: signals can be fuzzy. To that end, a distinction now needs to be made between signals and indices. "Indices" as defined by Jervis (1985) are:

> " ...statements or actions that carry some inherent evidence that the image projected is correct because they are believed to be inextricably linked to the actor's capabilities or intentions." (Jervis, 1985).

Indices, unlike signals, can not be easily manipulated. Examples include private messages the perceiver overhears or intercepts. In some sense, indices are an "external" type of signals that can not be manipulated (Spender and Grant, 1996; Choi and Lee, 1996). The ability to use indices depends on an actor's particular, or rare experience such as past success which other competitors can not imitate. Thus, only certain types of actors would have an incentives to use indices. But such indices help to overcome the intangibility inherent in industries such as financial services by providing a more accurate and truthful information about value.

4.4 Identity Strength and Indices

Group members vary in the strength of their identification with a group. Peteraf and Shanely define identity strength as:

> "...the level of identification of members with the group." (Peteraf and Shanely, 1997: 173).

Therefore, group identity must have an effect(s) on firm's performance. This effect must be positive, that is associated with strong identity. When a group identity is weak, the existence of the group itself must be called into question (Hatten and Hatten, 1987; Barney and Hoskisson, 1990). Therefore, strong group identity is associated with strong firm performance.

Identity strength is not only determined by the degree of social learning and social identification, but also by the ability to communicate a firm's value and resources more accurately to the market (Choi and Baden-Fuller, 1995). This is important especially in industries such as financial services where the quality and value may be difficult to ascertain and measure. Therefore, the greater the degree to which individual members engage in social learning and social identification behaviour, the stronger their identification with the group. The degree of social learning and social identification are accelerated by mutual understanding and mutual modelling. The higher the degree of both mutual understanding and mutual modelling, the higher the valuation of the association, and the stronger the identification with group. This is linked to the idea of market "indices" which provide a strong references to facilitate mutual understanding. Providing that indices, rather then signals, are inextricably linked to the actor's capabilities (Jervis, 1985), indices are associated with stronger identity. The stronger the indices projected to group members, the trustful the group's image, and the stronger the group's identity. Thus, indices provide conditions that maintain the dynamic aspects of strategic group identities (Peteraf and Shanley, 1997). Providing information on an actor's age, or information about the number of branches and stores implying the size of the client base are indices, rather than signals. Indices are more truthful and trustworthy. In this sense, actors who can provide indices rather than signals can provide much stronger trust and more sustainable co-operative exchange (Heil and Robertson, 1991; Barney and Hansen, 1994).

4.5 Strategic Group Identity, Indices and Sustainable Competitive Advantage

A firm's competitive advantage is seen as resting on distinctive processes, ways of co-ordinating and combining, shaped by the firm's specific assets positions such as the firm's portfolio of difficult-to-trade knowledge assets (Teece *et al.*, 1997). Dierickx and Cool (1989) and Hall (1993) focus precisely on those kinds of resources and capabilities which are of central concern to resource-based theory: nontradeable assets which develop and accumulate within the firm. Such assets tend to defy imitation because they have a strong tacit dimension and are socially complex. This is considered one of the cornerstones of firm's competitive advantage as long as knowledge assets are characterised by imperfect mobility as well (Peteraf, 1993). Therefore, strategic group identity, in terms of its intangibility and its hardness-to-imitate, should be considered a source of sustainable competitive advantage.

This idea is linked to a recent analysis of sustainable competitive advantage that combines the institutional and resource-based view of sustainable competitive advantage. Oliver's (1997) institutional theory suggests that institutionalised activities are the result of interrelated processes at the individual, organisational and interorganisational levels of analysis. At the individual level, managers' norms, habits and unconscious conformity to traditions account for institutionalised activities (Berger and Luckmann, 1967). At the firm level, corporate culture, shared belief systems and political processes supporting given ways of managing perpetuate institutionalised structure and behaviours. At the interorganisational level, pressures emerging from government, industry alliances and social expectations, rules, norms and standards about product quality, occupational safety, or environmental management, define socially acceptable firm conduct. Those social pressures, which are common to all firms in the same sector, cause firms to exhibit similar structures and activities (DiMaggio and Powell, 1983).

The basic premise of institutional theory, then, is that firms' tendencies toward conformity with predominant norms, traditions and social influences in their internal and external environments lead to homogeneity among firms in their structures and activities. In this sense, successful firms are those that gain support and legitimacy by conforming to social pressures. In contrast, the basic argument of the resource-based view is that rare, specialised, inimitable resources and resource market imperfections cause firm heterogeneity, and that successful firms are those that acquire and maintain valuable idiosyncratic resources for sustainable competitive advantage.

Strategic group identity, therefore, can be viewed as associated with both the institutional and resource-based view of sustainable competitive advantage. The basic premise of the institutional theory, that is conformity with social influences, implies and ensures the core of strategic group identity: that is the mutual understanding between and among group members. Conformity requires mutual understanding. At the same time, the basic premise of the resource-based view is resources' inimitability which leads to gain a sustainable competitive advantage. Once again, the distinctive characteristics of group identity, in terms of its intangibility, provide a condition for sustaining competitive advantage. The inimitable, i.e., intangible resources constitute a central element in Oliver's model of sustainable competitive advantage (Oliver, 1997). Thus, strategic group identity contributes significantly to sustaining group's, then firm's, competitive advantage. In that sense, indices, rather than signals, provide a sufficient condition to convey intangible resources to both the internal and the external environment. Therefore, indices are very important for knowledge-based industries to gain and sustain competitive advantage.

4.6 Strategic Reference Point Theory and Indices

The literature of the role of strategic management is rich of tools, mechanisms and insights that help to match and close the gap between internal organisational capabilities and external environmental demand (Andrews, 1987; Hofer and Schendel, 1978). This requires deep comprehension of how the organisational capabilities are evaluated and against what criteria these capabilities are evaluated. In this regard, Fiegenbaum *et al.* (1996) present "strategic reference point theory." It states that a firm's choice of 'reference points' can help achieve strategic alignment capable of yielding improved performance and potentially even a sustainable competitive advantage. In fact, the strategic reference points theory has its underlying roots in several major theoretical perspectives from economics, psychology and organisational theory. They all sought to identify targets or reference groups which expose gaps and thereby raise individual or organisational aspiration levels upon different elements or areas of content in establishing reference points. In sum, motivation theory (Latham and Yukl, 1975), prospect theory (Tversky and Kahneman, 1981) and the resources-based view of the firm (Wernerfelt, 1984; Barney, 1991) emphasise the importance of internal goals and capabilities to organisational behaviour and effectiveness. Similarly, industrial organisation economics (Porter, 1980), resources dependence (Pfeffer and Salancik, 1978) and institutional theory (Meyer *et al.*, 1983) all posit, in one way or another, the importance of external points of reference to strategic choice or firm survival. Finally, the literature on corporate identity (Dutton and Dukerich, 1991) and strategic intent (Hamel and Prahalad, 1989) both emphasise, among other things, the importance of time, with the former focusing on past traditions and values and the latter on future, long-term purpose and direction.

The theoretical perspectives described above show that they all share one common factor: the selection of a "reference point" against which strategic choice or organisational behaviour is judged. The core of the strategic reference point theory, therefore, is that by signalling organisational priorities and overall direction, top managers, whether knowingly or not, focus the attention of organisational members on particular goals and objectives. Therefore, strategic behaviour of organisations and their subsequent performance can be influenced directly by management's choice of reference points. In this sense, understanding a firm's choice of reference points is one way to achieve strategic alignment (Andrews, 1971; Hofer and Schendel, 1978; Itami, 1987). In this regard, the reference points imply that the management must work hard to send consistent messages and align strategies, systems and processes to achieve high performance. However, the organisation must also keep challenging to acquire new competencies so that it might be positioned for the future (Hart, 1992).

It is obvious that the strategic reference points require the organisational capabilities, goals and objectives to be well defined otherwise the reference points will be distorted. In this sense, indices, rather than signals, given they are inextricably linked to the actor's capabilities and intentions (Jervis, 1985), provide an accurate and well defined strategic reference points. By the same logic, it is necessary for top managers to focus on certain goals and objectives such as strategic reference points or indices that reflect, develop and enhance their firm's identity, otherwise the organisational performance will be distorted and turn out to be uncompetitive. This shows the link between strategic reference points theory, indices, and firm's identity.

4.7 Drivers of Identity in Financial Services Industries: Theoretical Framework

In financial services industries, external intermediaries can also play a potential role in "certifying" the content and value of an actor's products or services. Burt and Knez (1996) analyse in detail the importance of passive as well as more active intermediaries, or third parties, and their role in the sustainability of co-operative relationships. The key issue is that a firm's identity in the market place for financial services based industries is determined by four "Drivers of Identity," which help to "certify" the quality, value and content of the actor's products or services. This idea overlaps with recent works such as Podolny (1993), Camic (1992) and Haunschild (1994) which have recently further developed the earlier works of White (1970), Sorensen (1983), Burt (1982), Bonacich (1987) and Simmel (1950) to show that an actor's position in the social structure can turn affect not only rewards, but can reduce the actor's ability to interact with actors with different social status. The researcher believes that the basic idea of interdependence can be taken further. With assets such as knowledge, where the value and content of the product or service being exchanged are uncertain, external cues like intermediaries help to identify and certify an actor and its products or services' value and quality in the market place. The ability to develop long-term trust relations with certain "drivers of identity" will in turn determine an actor's competitive advantage in the market place.

The literature includes four major indices or drivers of identity for actors in financial services industries (Choi and Lee, 1996). Firstly, an actor's client base is a driver of identity. The position or status (Podolny, 1993; Frank, 1988) of the particular clients can in turn help to elevate and provide an index, rather than signal, of the firm's ranking and identity. Secondly, the ability and reputation for being innovative such as developing new products and a dynamic corporate culture are another type of index in the market place for financial services based industries (Haunschild, 1994). Thirdly, a firm's networks, whether they be with collaborators, or with competitors can also be an index in the market place. An example of this would be top ranked business schools (D'Aveni, 1996) being competitors but holding executive programmes or other conferences together in a network. Fourthly, outside or external sources of information (external intermediaries) such as Standard and Poor indexes in financial markets, consumer reports written by private organisations, business magazines and commentaries all help to serve as an index of quality.

In financial services industries, because of the intangibility and difficulties in measuring the value and content of products and services, the market tries to identify such quality, content and value through "indirect" ways. Such external cues, which provide indirect information, are indices and are provided by these four major drivers of identity. These four major indices, which are linked to firms through trust-based "institutional" relationships, can help determine an actor's identity and relative position. The four 'drivers of identity' are shown in figure (4-1).

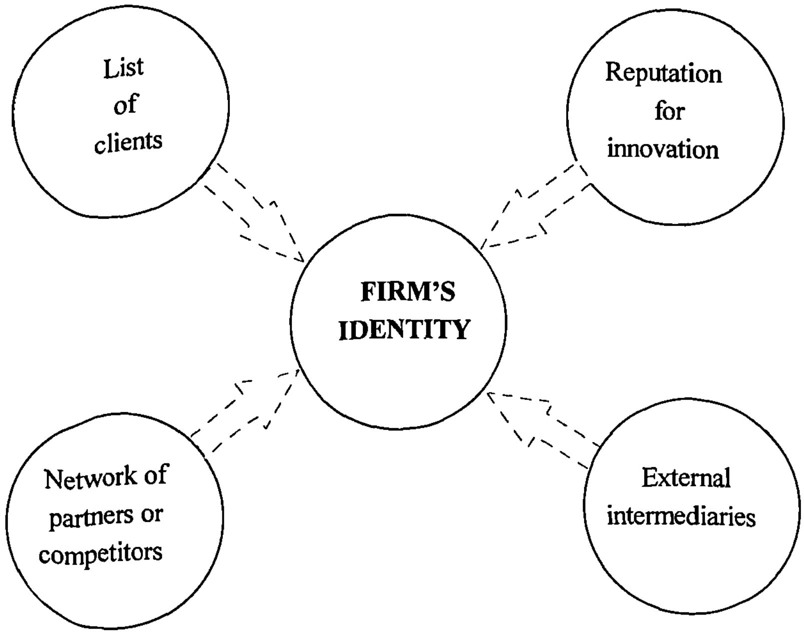


Figure (4-1): Four Drivers of Identity

4.8 Drivers of Identity: An Empirical Evidence

4.8.1 Content Analysis

The four drivers of identity are examined in the banking industry as an example of an industry characterised by product intangibility. A content analysis (manifest content and latent content) has been undertaken for each of the bank's advertisements to determine what information each bank mentions and emphasises. Then, a number of measures were derived as a proxy for each of the four drivers of identity mentioned earlier. Bank's reputation for clients is taken as a proxy for the first driver of identity: *List of Client.* Information about banks' Chief Executive Officer (CEO) is taken as a proxy for the second driver of identity: *Reputation for innovation and change*. Information about banks' age and geographic spread is taken as a proxy of the third driver of identity: *Network of partners or competitors*. Information about banks' profits, size and country of origin is taken as a proxy of the fourth driver of identity: *External intermediaries.* Proxies of drivers of identity are taken as the independent (explanatory) variables.

4.8.2 Data Normality

For testing the normality of the data, a 'chi-square goodness of fit' (χ^2) test is carried out for each of the variables used in the study. The results are shown in table (4-1).

Table (4-1): The statistical results of χ^2 test of the variables: "Drivers of Identity" [6]

Variables	*p*-value
Bank's reputation for clients	0.054
Bank's chief executive officer	0.059
Bank's age	0.057
Bank's geographic spread	0.06
Bank's profits	0.043
Bank's size	0.053
Bank's country of origin	0.07

The results in table (4-1) show that only one variable (Bank's profits) out of the seven variables is not normally distributed (p-value < 0.05). This means that approximately 85.71 per cent of the data is normally distributed.

4.8.3 Data Validity

4.8.3.1 *Content and construct validity*

The variables used as proxy of drivers of Identity are considered basic factors that determine the importance and strength of the corporate social ties and external cues. The literature on corporate social structure and social networks focuses basically on the firm's relative position, or its status, as one

[6] The χ^2 test is carried out at the significance level 95%.

of the important factors that determine its relative position in the marketplace (Feld, 1981; Coleman, 1990). The magnitude of this literature provides an adequate source of the content validity of the variables drawn from this literature.

The construct validity of these variables is assured since those variables have been examined by many scholars in various social and business studies. In addition, those variables are well defined in the literature. In this regard, it is worth to mention that this study extends this applied literature to the financial services industries, e.g., banks as the application sector in this study.

4.8.3.2 *Discriminant validity*

The discriminant validity in this study can adequately be assessed on a descriptive basis. That is, there is no overlap between or among those variables in terms of their definition or their application. Therefore, each variable is considered a discriminant factor to firm's status in the marketplace.

4.8.4 Data Reliability

As the main objective of the study is to explore the effects of the drivers of identity on the financial services industries, e.g., banks, the study is designed to examine the effects of the drivers of identity for each bank under three different cases. Firstly, when the drivers of identity are not mentioned in the bank's advertisement, secondly when they are mentioned, thirdly when they are emphasised upon. Therefore, a Reliability Analysis is carried out for each case separately (Churchill, 1979; Nunnally, 1967). Table (4-2) shows the results of the analysis.

Table (4-2): Reliability Analysis of the "Drivers of Identity"

Drivers of Identity	***Alpha***	**F-Ratio**	***p*-value**
Not mentioned	0.60	20.92	0.00
Mentioned	0.67	7.42	0.00
Emphasised	0.73	14.36	0.00

The results in table (4-2) show that the *Alpha* coefficients are relatively acceptable as the "Drivers of Identity" themselves, and the three cases under which the "Drivers of Identity" are examined is considered a new type of study (Churchill, 1979; Nunnally, 1978). All of the *Alpha* coefficients are significant at the level 5%.

4.8.5 The Dependent Variables

As for the dependent variables, they are drawn from POLK World Banking Profiles (1996) which include variety of banks performance measures. The measures are classified into four basic categories as follows.

1. **Profitability measures**: which include Operating Income/Total Assets and Net Interest Income/Total Revenue. The researcher included the Return on Assets (ROA) to these measures considering it is an acceptable and commonly measure of financial performance.
2. **Liquidity measures**: which include Liquid Assets/Total Assets, Liquid Assets/Deposits and Liquid Assets/Deposits & Borrowing.
3. **Assets Quality measures**: which include Non-performing Loans/Total Loans, Reserves/Gross Loans and Provisions/Gross Loans.
4. **Capital Adequacy measures**: which include Shareholders Equity/Total Assets, Capital Funds/Total Assets and Deposits/Total Assets.

Four of the above measures are used as dependent variables. The four dependent variables are chosen according to the results of the correlation matrix (Appendix 4-1). The four dependent variables are as follows.

1. Return on Assets (ROA).
2. Non-performing Loans/Total Loans (NPL).
3. Shareholders Equity/Total Assets (SHE).
4. Deposits/Total Assets (DEP).

4.8.6 Empirical Results

The empirical results are divided into three levels. Each of them indicates different and distinguished phase of the impacts of the drivers of identity. These three levels are:

Level 1: The impact of the drivers of identity on banks' performance measures. This level tests which of the drivers of identity' is (are) most influential on the banks' performance measures.

Level 2: The impact of the drivers of identity on 'Highly versus Lowly ranked banks.'[7] This level tests the impact of the most influential drivers of identity on performance measures of the 'Highly versus Lowly ranked banks.'

Level 3: The importance of the drivers of identity of 'Highly versus Lowly ranked banks' to each business system. This level tests whether any of the most influential drivers of identity makes any difference in each business system.

[7] 'Highly ranked banks' denote to those banks that are given high ranks using different criteria adopted by many of the well-known ranking organisation such as 'Financial Commitments' adopted by Standard & Poor, 'Financial Strength' adopted by Moody's, 'Credit-Worthiness' adopted by IBCA, 'Financial Stability' adopted by Thomson Bank Watch, and banks' role as M&A advisers adopted by Institutional Investor.

Level 1: The impact of "Drivers of Identity" on banks' performance measures

As for level 1, table (4-3) shows the results of the Stepwise Regression Analysis for the drivers of identity on banks' performance measures. The regression analysis is carried out when drivers of identity are emphasised upon by banks.[8] The results show that five out of the seven drivers of identity have statistically significant impacts on the four banks' performance measures (the four regression equations). The five drivers of identity are banks' Age, CEO, Country of Origin, Reputation for Clients, and Size respectively.

[8] The drivers of identity (the explanatory variables) are symbolised as follows. Bank's Reputation for Clients = Reputation; Bank's Chief Executive Officer = CEO; Bank's Age ≠ Age; Bank's Geographic Spread = G.spread; Bank's Profits = Profits; Bank's Size = Size; Bank's Country of Origin = COO.

Table (4-3): Results of the Stepwise Regression of "Drivers of Identity" on banks performance measures: When 'Drivers of Identity' are emphasised [1]

Performance measures	ROA	NPL	SHE	DEP
Constant	40.01 (3.77)*	-0.39 (-0.51)	6.11 (10.42)*	48.36 (8.38)*
Reputation			0.02 (1.76)***	
CEO	0.85 (3.70)*			
Age	0.48 (1.78)***			
G.spread				
Profits				
Size				0.41 (3.86)*
COO		0.04 (2.21)**		
Adjusted R^2	0.23	0.09	0.08	0.26
F-Ratio	6.98*	4.92**	3.08***	14.88*
VIF	Age 1.14 CEO 1.14	COO 1.00	Reputation 1.00	Size 1.00
D-W statistic	2.24	2.31	2.53	2.15
N	40	40	38	40

1 t-statistics are given in parentheses.

* Estimates are significant at the significance level 99%.

** Estimates are significant at the significance level 95%.

*** Estimates are significant at the significance level 90%.

Each regression equation is tested for multicollinearity among the explanatory variables (drivers of identity) using the Variance Inflationary

Factor (VIF) under the following two hypothesises:

$$H_0 : \text{the X's are orthogonal}$$
$$H_1 : \text{the X's are not orthogonal}$$

where X's = Drivers of Identity

The results show that the four equations are free from multicollinearity among the explanatory variables [the correlation matrixes of the explanatory variables are listed in Appendixes (4-2) - (4-5)].

An autocorrelation test is carried out using D-W (Durbin-Watson) test (Koutsoyiannis, 1977; Gujarati, 1992; Greene, 1997) under the following two hypothesises:

$$H_0 : \rho = 0 \text{ (the } u\text{'s are not autocorrelated)}$$
$$H_1 : \rho \neq 0 \text{ (the } u\text{'s are serially dependent)}$$

where ρ = the coefficient of the autocorrelation relationship.

The results of the autocorrelation analysis show that the four regression equations are free from autocorrelation among u's where $d^* > d_U$ at the significance level 1%. That is, the null hypothesis is accepted.

The impacts of the five drivers are not equal on the four regression equations according to the different statistical significant level (p-value) for each equation. The first and the fourth equation show higher significance (p-value < 0.01), then the second equation (p-value < 0.05), and finally the third equation (p-value < 0.10). The most influential drivers are banks' Size, CEO, Country of Origin, Age and Reputation for Clients respectively.

The results show that banks' ROA is affected to a large extent by the quality of the management represented by the CEO and to a less extent by the banks' age. Banks' non-performing loans (NPL) equation is affected by the Country of Origin. This result reflects the effects of the different institutional infrastructure in different business systems the banks belong to. That is, the general idea behind the significance of the institutional infrastructure tells that the stronger the enforcement laws, the less the NPL and vice versa. The banks' Shareholder Equity/Total Assets (SHE) equation is affected by banks' Reputation for Clients. This indicates that shareholders are not only affected by the banks profits (the conventional measure) but they can also be affected by the strength of the banks-clients networks. The last regression equation shows that banks' Deposits/Total Assets (DEP) is affected significantly by the size of the bank. This result matches the reality of the banking business. That is, the size of a bank determines the deposits the bank does have in the present and what is expected in the future as well.

Level 2: The impact of 'Drivers of Identity' on Highly versus Lowly ranked banks

As for level 2, tables (4-4) and (4-5) show the results of the linear regression of drivers of identity on the performance measures of the highly versus lowly ranked banks. As the main issue in this level is to test the impact of drivers of identity on performance measures, the analysis focuses on the data that represents the emphasised drivers of Identity. The reason for choosing this option is that these drivers are the most likely to influence banks' performance.

Table (4-4): Results of the Stepwise Regression of the 'Highly ranked banks:' when 'Drivers of Identity' are emphasised [1]

Performance measures	ROA	NPL	SHE	DEP
Constant	1.14 (5.79)*	Non of the variables is statistically significant	7.23 (12.73)*	65.84 (7.50)*
Reputation				0.54 (2.68)*
CEO			0.02 (1.87)***	0.45 (2.82)*
Age				
G.spread				
Profits				0.34 (1.75)***
Size				
COO	0.02 (3.11)*		0.06 (4.46)*	0.71 (3.25)*
Adjusted R^2	0.33		0.50	0.36
F-Ratio	9.72*		10.06*	3.56**
VIF	COO 1.00		CEO 1.11 COO 1.11	CEO 1.14 COO 1.16 Profit 1.19 Reputation 1.17
D-W statistic	1.82		2.17	1.82
N	19		19	19

1 *t*-statistics are given in parentheses.

* Estimates are significant at the significance level 99%.

** Estimates are significant at the significance level 95%.

*** Estimates are significant at the significance level 90%.

Table (4-4) shows the results of the linear regression for the 'Highly ranked banks.' Each regression equation is tested for multicollinearity among the explanatory variables (Drivers of Identity) using the Variance Inflationary Factor (VIF) under the following two hypothesises:

$$H_0 : \text{the X's are orthogonal}$$
$$H_1 : \text{the X's are not orthogonal}$$

where X's = Drivers of Identity

The results show that the four equations are free from multicollinearity among the explanatory variables [the correlation matrixes of the explanatory variables are listed in Appendixes (4-6) - (4-8)].

An autocorrelation test is carried out using D-W (Durbin-Watson) test (Koutsoyiannis, 1977; Gujarati, 1992; Greene, 1997) under the following two hypothesises:

$$H_0 : \rho = 0 \text{ (the } u\text{'s are not autocorrelated)}$$
$$H_1 : \rho \neq 0 \text{ (the } u\text{'s are serially dependent)}$$

where ρ = the coefficient of the autocorrelation relationship.

The results of the autocorrelation analysis show that the three regression equation are free from autocorrelation among u's where $d^* > d_U$ at the significance level 1%. That is, the null hypothesis is accepted.

The results show that banks' drivers of identity have different impacts on performance measures taking into account the different degrees of adjusted R^2 of each regression equation. Moreover, only four out of the seven drivers of identity are statistically significant. These are banks' CEO, Country of Origin, Profits and Reputation for Clients. The four drivers of identity explain most of the variations in banks' Deposits/Total Assets. This result proves that these drivers of identity are significantly contributing to banks' performance taking into account that deposits represent one of the core components of the banking business. Nevertheless, it seems that shareholders equity is influenced to a relatively high degree by banks' CEO and Country of Origin. The results also show that banks' drivers of Identity are not statistically significant when explaining banks' Non-Performing Loans/Total Loans. This result can be explained by the fact that banks' non-performing loans represent clients' defaults which are more associated with their business types and/or conditions than with what banks emphasis on to convey their identity.

Nevertheless, table (4-4) shows that drivers of Identity are contributing less to banks' ROA where only one variable (Country of Origin) is statistically significant in this equation and it is associated with the lowest adjusted R^2. This seems logic where the results of the Stepwise Regression Analysis in table (4-3) show that banks' profits is not selected among the drivers of identity.

Table (4-5): Results of the Stepwise Regression of the 'Lowly ranked banks' when 'Drivers of Identity are emphasised [1]

Performance measures	ROA	NPL	SHE	DEP
Constant	0.21 (0.48)	4.75 (4.09)*	7.23 (2.75)*	65.22 (9.79)*
Reputation	0.02 (1.91)***		0.15 (2.34)**	
CEO		0.03 (1.69)***	-0.07 (-2.08)**	
Age				0.55 (2.71)*
G.spread				
Profits				0.52 (2.40)**
Size				
COO				
Adjusted R^2	0.12	0.09	0.23	0.25
F-Ratio	3.67**	2.86***	3.98**	4.30**
VIF	Reputation 1.00	CEO 1.00	Reputation 1.06 CEO 1.06	Age 1.4 Profit 1.4
D-W statistic	1.52	1.75	2.64	2.75
N	21	19	21	21

1 *t*-statistics are given in parentheses.

* Estimates are significant at the significance level 99%.

** Estimates are significant at the significance level 95%.

*** Estimates are significant at the significance level 90%.

The results in table (4-5) show that the performance measures of the 'Lowly ranked banks' are affected by four out of the seven drivers of identity. These are the banks' Reputation For Clients, CEO, Age and Profits respectively.

Each regression equation is tested for multicollinearity among the explanatory variables (Drivers of Identity) using the Variance Inflationary Factor (VIF) under the following two hypothesises:

$$H_0 : \text{the X's are orthogonal}$$
$$H_1 : \text{the X's are not orthogonal}$$

where X's = Drivers of Identity

The results show that the four equations are free from multicollinearity among the explanatory variables [the correlation matrixes of the explanatory variables are listed in Appendixes (4-9) - (4-12)].

An autocorrelation test is carried out using D-W (Durbin-Watson) test (Koutsoyiannis, 1977; Gujarati, 1992; Greene, 1997) under the following two hypothesises:

$$H_0 : \rho = 0 \text{ (the } u\text{'s are not autocorrelated)}$$
$$H_1 : \rho \neq 0 \text{ (the } u\text{'s are serially dependent)}$$

where ρ = the coefficient of the autocorrelation relationship.

The results of the autocorrelation analysis show that the four regression equation are free from autocorrelation among u's where $d^* > d_U$ at the significance level 1%. That is, the null hypothesis is accepted.

The four drivers of identity are associated with the highest adjusted R^2 of the banks' equation of Deposits/Total Assets, although it is not as high as that of the 'Highly ranked banks.' The results also show that the 'Lowly ranked banks' share the 'Highly ranked banks' in emphasising on three drivers of identity: the banks' CEO, Profits and Reputation for Clients. The 'Lowly ranked banks' differ in their emphasis on their 'Age' which shows a statistically significant impact on the banks' Deposits/Total Assets.

The comparison of the results in table (4-4) and table (4-5) to those of table (4-3) shows a significant implication. Firstly, banks' drivers of identity - excluding only banks' Geographic Spread - affect to a significant degree the banks basic performance measures. Secondly, the comparison between the adjusted R^2 of the 'Highly' versus the 'Lowly' ranked banks shows that banks' drivers of identity explain larger percentage of the performance measures for the 'Highly ranked banks' than they do for the 'Lowly ranked banks.' This emphasises the fact that 'Highly ranked banks' gain some benefits by emphasising on the six drivers of identity when conveying information to their stakeholders. This conclusion, therefore, is of special importance to 'Lowly ranked banks.' That is, the latter should give special attention to those drivers of identity that help their stakeholders to highly identify their products and services, thus their identity and performance measures.

Level 3: Influences between different business systems

As this level is focusing on comparing the three basic business systems (the Anglo-Saxon, the Communitarian, and the Asian/emerging business systems), *TUKEY'S HSD* (Honestly Significant Difference) test is used to carry out pairwise comparisons under the following general hypothesis:

$$H_0 : \mu \text{ for any two business systems is equal}$$
$$H_1 : \mu \text{ for any two business systems is not equal}$$

Table (4-6): *TUKEY-HSD test* for the Highly ranked banks (when banks emphasise on "Drivers of Identity")[1]

Business Systems / Variables	Anglo-Saxon	Communitarian	Asian/Emerging
Size			
Mean	49.99	48.80	23.61
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.41		
Age			
Mean	29.74	38.35	29.16
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.69		
CEO			
Mean	25.10	23.94	23.61
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.01		
Country of Origin			
Mean	43.24	36.14	47.22
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.31		
Reputation for Clients			
Mean	41.59	52.07	41.66
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.82		
Geographic Spread			
Mean	61.20	58.19	56.94
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.05		
ROA			
Mean	0.68	0.52	0.38
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.51		
NPL			
Mean	4.74	4.35	2.33
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.55		
SHE			
Mean	4.88	5.02	4.16
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.42		
Dep			
Mean	67.25	76.18	64.09
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.27		

1 $N = 19$

Table (4-6) shows the means of the 'Highly ranked banks' when they emphasise on drivers of Identity, in addition to measures of performance. It seems that drivers of identity are of equal importance to all banks whatever the business system they belong to.

Table (4-7): *TUKEY-HSD test* for the Lowly ranked banks (when banks emphasise on "Drivers of Identity")[1]

Variables \ Business Systems	Anglo-Saxon	Communitarian	Asian/Emerging
Size			
Mean	40.30	52.13	37.96
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.16		
Age			
Mean	31.85	41.38	43.51
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.15		
CEO			
Mean	5.55	31.52	24.53
TUKEY-HSD test	*The Communitarian banks differ significantly from Anglo-Saxon and Asian/Emerging banks at the 0.05 level*		
F-Ratio	5.96*		
Country of Origin			
Mean	28.64	53.78	68.05
TUKEY-HSD test	*The Communitarian and Asian/Emerging banks differ significantly from Anglo-Saxon banks at the 0.05 level*		
F-Ratio	10.75*		
Reputation of Clients			
Mean	41.49	41.15	39.81
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.02		
Geographic Spread			
Mean	55.53	49.72	39.35
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.54		
ROA			
Mean	1.54	0.38	1.19
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	3.03		
NPL			
Mean	25.54	3.98	2.81
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.35		
SHE			
Mean	8.61	6.91	7.61
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	0.16		
Dep			
Mean	62.43	75.57	63.89
TUKEY-HSD test	*no two groups are significantly different at the 0.05 level*		
F-Ratio	1.05		

1 $N = 21$

* Significant at the significance level 95%.

Table (4-7) shows different results with the same variables for 'Lowly ranked banks'. It shows that both of the CEO and the Country of Origin distinguish between the three business systems. As for the CEO, the results show that the CEO is of special importance to Communitarian banks, and is of equal importance to the other two business systems.

As for the Country of Origin, the results show that it is of special importance to the banks that belong to Communitarian and Asian/emerging business systems. This result may be explained by the fact that both of those two business systems contain economies in-transition which are of major and distinguished concern for investors around the world. This is why it makes difference for banks in those two business systems to emphasise on their Country of Origin. In general, the results of level 3 indicate that the drivers of identity are relatively important to Communitarian and Asian/emerging business systems than to the Anglo-Saxon business system.

4.9 Conclusion

This chapter concludes that bank's drivers of identity are considered very important factors that determine its relative position in the marketplace. That is, the drivers of identity are equivalent to, and in fact stem from, various stakeholders interests. This issue is very important to the financial services industries as long as product intangibility is considered a distinct feature that necessitates to address non-financial measures of corporate governance.

More interestingly, the chapter shows that certain drivers of identity positively affect banks performance, thus their relative competitive position in the marketplace. Furthermore, the results show that Banks' drivers of identity are relatively important to different business systems. More specifically, the highly ranked banks benefit more from focusing on drivers of identity than the lowly ranked banks.

Chapter 5

Monitoring Corporate Performance and Governance in Transitional Markets: An Application to Egypt

5.1 Introduction

This chapter introduces in-depth insights concerning emerging markets in transition. These markets have undergone radical changes since the 1980s. The most notable change is their path to rapidly capitalise their economies which has led many scholars to adopt the stock market measures used for corporate monitoring in the capitalist economies. The recent decline in the stock markets in emerging markets suggests that corporate performance in transitional markets must be monitored through additional measures including the stock market ones.

In this sense, as the two preceding chapters conclude that corporate stakeholders orientation provides sources of identification that can enhance corporate relative position in the marketplace, this chapter, therefore, explores how this identification can be monitored in transitional emerging markets, and what type of information can be released by companies to their stakeholders. This idea is shown the Figure (5-1).

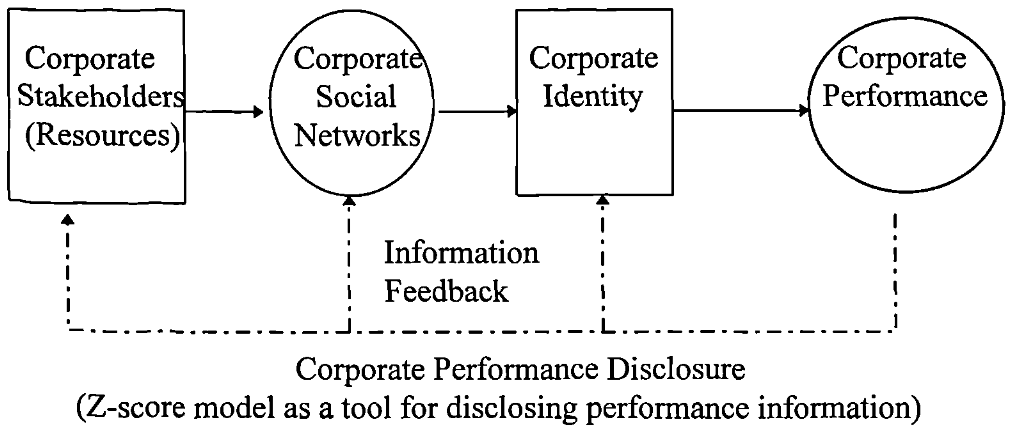


Figure (5-1): Corporate governance and corporate performance: An extended approach

Figure (5-1) illustrates that corporate stakeholders provide tangible/physical resources needed by a company for production purposes, whereas corporate identity, which is closely related to stakeholders identification, provides the intangible resources needed by a company to strengthen its relative competitive position in the market place. It is obvious, therefore, that corporate performance can be affected not only by stakeholders contribution but also by their perception and evaluation of the company's products and/or services.

For this purpose, this chapter builds a **Z**-score model, which is a statistical model that has been recognised as a practical tool for monitoring corporate performance. The work is applied to the textile sector in Egypt as it is recognised a transitional economy.

5.2 International Business Systems in Comparative Research

The revival of interest in comparative economic, political, social organisation and institutions in academic research has been around the issue of competing models of capitalism, or *business systems* as the sustained success of the German and Japanese economies provides an alternative model of political economy often called, alliance or Communitarian capitalism (Choi, *et al.*, 1996; Gerlach and Lincoln, 1992; Dunning, 1996). There has also been an intense debate on the reform of corporate governance systems coupled with various initiatives of corporate restructuring in both the Anglo-Saxon countries and the Communitarian countries (Bowman and Useem, 1995). In addition, there is a compelling need for an applicable model of business systems for the former Eastern bloc countries as well as other emerging market countries. The works in the international business environment such as Porter (1990), Ohmae (1985), Thurow (1992) argue that the increasing homogenisation of demand, technology and income levels in the three triad markets (United States, Western Europe and Japan) tend to shape managerial mind sets and decision making in global competition. This view is often extended to the argument that globalisation of markets and the convergence of demand under this triad framework allow firms to allocate their resources and activities freely across these three regions, thus leading to increased economies of scale and scope by standardisation of products and services, minimisation of costs, and the formation of flexible organisational structure.

Other researchers have discussed the importance of national institutions and capabilities: Stopford and Strange (1991), Lodge (1990) and Doz and Prahalad (1984) on business government relations; North (1996) and Williamson (1985a) on economic institutions; Kogut (1991) and Shan and Hamilton (1991) on technological capabilities and national systems of innovation; Sorge (1991) and Huntington (1996) on societal contingencies and elective affinities; Whitley (1990) and Child and Monir (1983) on comparative forms of business organisations and management systems. These works, elaborating on the global standardisation and local adaptation debate, have helped to analyse the complex realities of institutional and organisational diversity that still persist in today's increasingly converging global business environment. The researcher further suggests that the business system of a country or a group of countries consisting of various institutional and cultural factors is a crucial determinant in analysing the differential modes of organisation and strategy as well as differential rates of performance in today's global competition.

As the researcher discussed earlier, the traditional analysis of the triad popularised in works such as Ohmae (1985) and Thurow (1992) is defined by the similarity of income and other demand factors across the triad. This is shown in Figure (5-2). But that analysis does not take into account the role of emerging market countries and their firms in global competition.

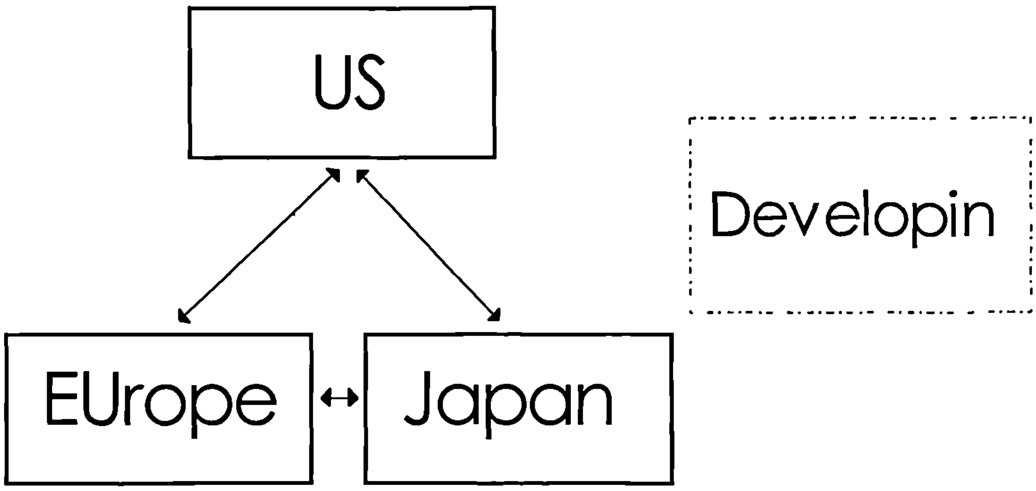


Figure (5-2): Traditional models in international management: Geography and wealth based

Figure (5-2) shows that global competition can be seen from the viewpoint of what motivates and constrains firm strategy and behaviour in today's global business environment. Such factors or constraints include national culture, legal and regulatory environment, business-government relationship, the role of financial institutions and corporate governance system in the home market as well as the host countries of multinational firms.

It is worth to realise that globalisation and the competition between and among competition-driven countries do not mean that differences between the latter and economics-driven countries do not exist. Accordingly, the importance of the national business environment in influencing the organising principles and competitive strategies of firms has been analysed in Stopford and Strange (1991), Kogut (1991) and Albert (1993). According to their analysis, domestic institutions play as important role in determining corporate behaviour as the pressures of globalisation. For example, in many parts of Asia, it is not financial markets but various government ministries that monitor corporate performance and control financial allocation. In many continental European countries such as Germany and Switzerland, the banking sector, as institutional shareholders, monitors corporate performance and investment decisions. Firm behaviour and strategy, especially investment decisions such as new market entry, diversification and innovation and new product development can be significantly constrained by the differences of home market institutions while at the same time provide sources of competitive advantages that may or may not be transferred across national boundaries. These constraints, in turn, determine the scale and scope of collaborative activities across national boundaries. That is, in spite of the global nature of today's competition, the political, economic and socio-cultural effects of home market institutions can have both positive and negative influence on firm capabilities and competitive advantages.

The *Anglo-Saxon* business system, or capitalism (Albert, 1993) has been economically dominant in the 19th and 20th centuries. Although the term 'West' is often used to describe both North America and Western Europe as a relatively homogenous grouping of countries, in terms of economic and political systems, there is a significant difference between Anglo-Saxon countries such as the United States, Canada and the United Kingdom and those of continental Europe. The latter countries are also Western, but very different from the Anglo-Saxon countries in terms of their domestic business system which emphasises the role of the government in economic and social affairs, the close linkages between banking and industry and the group orientation of the society and *Communitarian* values.

The *Emerging markets* refer to a broad range of countries that are rapidly entering the world business system. They include most of the Asian countries, some of the Eastern European countries such as Russia, Hungary and Czech Republic, and some of the Latin American countries such as Mexico, Chile and Brazil. These countries, in turn, have to be distinguished from the developing countries of the world. This can be shown in Figure (5-3). Due to their phenomenal economic growth, the emerging markets have become a key focus for personal and institutional investors as well as for international corporations.

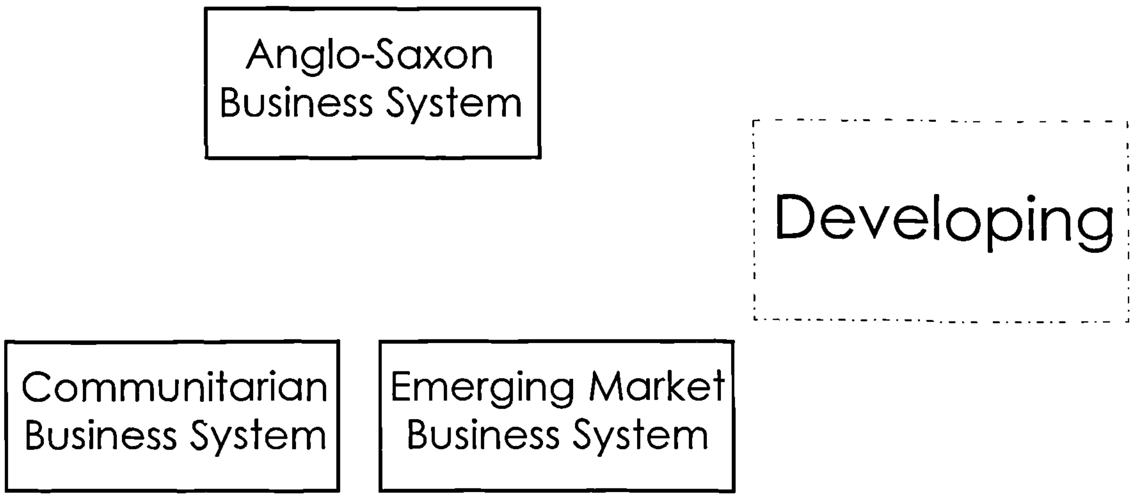
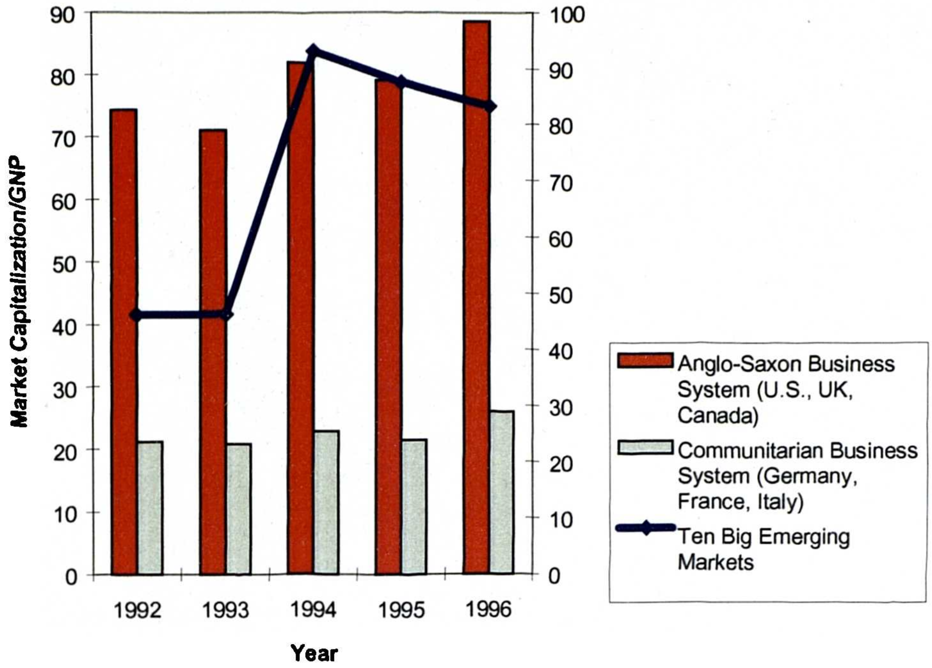


Figure (5-3): Home market institutions and constraints

5.3 Corporate Governance and Adaptable Governance in Transitional Emerging Markets

The emerging markets represent undeniable commercial opportunities. In the last decade, the ten big emerging markets - Mexico, Brazil, Argentina, South Africa, Poland, Turkey, India, South Korea, the ASEAN region (Indonesia, Thailand, Malaysia, Singapore, and Vietnam), and the Chinese Economic Area (China, Hong Kong, and Taiwan) - have opened their markets to foreign investment and trade. The GDP of the big emerging markets has been increasing two to three times faster than that of the developed countries. At the same time, the emerging markets have made genuine progress in putting deficits and inflation under control as well as in selling off bloated state enterprises to private investors.

Until the late 1990s, the capitalist path of development has been observed as the most favourable path to speed up economic reform in the emerging markets. Private capital has been flowing to the emerging markets in unprecedented amounts, rising from 19% in 1996 to a new high of $230 billion. Enormous potential exists for further expansion: for example, whereas all emerging markets account for 40% of global production, they still represent only 15% of global stock market value (Garten, 1997a,b). Nevertheless, recently the East Asian crises raised concern about the viability of the emerging market business system as a medium of continued economic growth (Lee, *et al.,* 1998). Figure (5-4) shows that the Market Capitalisation/GNP in the big ten emerging markets has been rising sharply since 1993, then started to decline since 1994.



Figure(5-4): Market Capitalisation/GNP of Comparative Business Systems

* Source: The values of each county's Market Capitalisation and GNP are drawn from The International Financial Statistics, Vol. L, No. 11, November 1997; Emerging Stock Markets Factbook, International Finance Corporation.

This gives rise the fact that the economic growth in emerging markets has been financed by the stock market – the common institution in the capitalist economies – as much as it has been by other institutions such as banks. In addition, the private capital flows into the big ten emerging markets at the beginning of the 1990s were aiming at benefiting from the so-called first mover advantage (Andrews, 1996). This is the green light, as Andrews points out, that has been encouraging private investors to turn to the new markets seeking more profits from not-yet-saturated markets. However, it is obvious that those investors have not been aware of the underlying economic facts inherent in many of the emerging markets: low per capita income, fragmented distribution systems and tariff and import limits. This is the yellow light that investors should have been aware of.

In terms of the distinct differences between the major international business systems, the relative position of the emerging markets between the Anglo-Saxon and the Communitarian business systems tells that market capitalisation in emerging markets has been sloping downward since 1992 to resemble relatively the Communitarian one. This trend is depicted in figure (5-5).

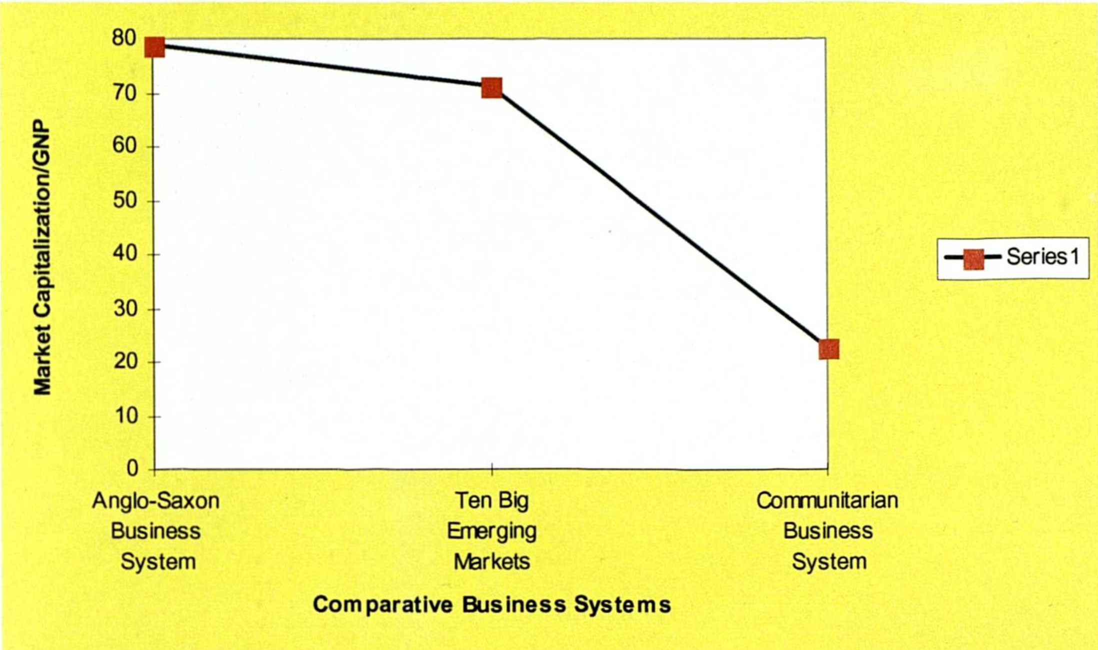


Figure (5-5): Trend of Market Capitalisation/GNP of Comparative Business Systems

* Source: The values of each county's Market Capitalisation and GNP are drawn from The International Financial Statistics, Vol. L, No. 11, November 1997; Emerging Stock Markets Factbook, International Finance Corporation.

Therefore, there are considerable evidences to indicate that the tides of capitalism, which rose so powerfully after the collapse of the Soviet Union, are poised to recede (Garten, 1997a,b). In sum, the lack of well-adaptable institutional infrastructure (Lee *et al.*, 1998; Khanna and Palepu, 1997a,b; Kuznetsova and Kuznetsov, 1998), the clash of capitalism and democracy that has resulted in political turmoil in many emerging markets (Garten, 1997a,b) and the weak economic infrastructure (Andrews, 1996) have all resulted in a considerable degree of uncertainty that led the private capital to drawback as the economic, social, and political infrastructure could not help international investors to sustain profits in the long run.

5.4 Corporate Governance, Disclosure and Monitoring Corporate Performance

In terms of the transitional economies' business system, the institutional infrastructure in most of the transitional emerging markets is characterised by weakened bureaucratic controls and tolerance of private ownership (Fischer and Gelb, 1991; Peng, 1994). As a result, the most observable features of doing business in transitional economies are the rely on network contacts and personal trust to minimise the uncertainties associated with the changing environment (Xin and Pearce, 1994). However, personal contacts and trust do not last long enough if the institutional infrastructure is weak. This, therefore, can explain the recent turmoil in the emerging markets when western investors started not to depend heavily on personal contacts and trust as long as political, economic and social instability are observed and even started to negatively affect their business in these transitional countries. In fact, as the stock prices in transitional economies have played an important informational role (Dow and Gorton, 1997) to reflect the deficiencies in their stock markets, the weaknesses of the internal capital market, such as bank relationships, have put the inadequacy of the institutional infrastructure on the surface of the commercial transactions (World Bank: Directions in Development, 1997).

The above reveals the necessity of changing corporate governance arrangements to cope with the relatively high degree of uncertainty associated with the institutional infrastructure of transitional economies. In this sense, disclosing more information about the corporate activities can play dual role at the macro level and the micro level as well. At the macro level, more disclosure can mitigate the negative effects of uncertainty, and at the micro level more disclosure proves to both corporate insiders and outsiders that corporate board of directors and corporate managers are accountable and responsible for enhancing corporate performance to the benefits of its stakeholders (Cadbury, 1993; Forker, 1992). Moreover, disclosure arrangements have been the focal point of the proposals for corporate governance reform proposals in number of developed countries. In the UK, Tricker and Robert (1984), Charkham (1989), Cadbury (1993) and the Committee on the Financial Aspects of Corporate Governance (1995) discuss the role of disclosure in proposals of corporate governance reform. In the U.S., the country where the major concern of the Securities and Exchange Commission (SEC) is the disclosure reform, the inconclusive nature of the disclosure quality is illustrated by successive revisions of the American Law Institute proposals (American Law Institute, 1982, 1990; Gilson and Kraakman, 1992). Nevertheless, in terms of Corporation Law, disclosure reform proposals in the U.S. could not yet achieve full benefits to the stockholders (Balck, 1991; André, 1991).

Williamson's (1985b) analysis of transaction costs provides a framework linking disclosure quality to corporate governance. This is integrated with the positive 'theory of agency' developed by Jensen and Meckling (1976) to provide a model of the disclosure decision of management. Management are assumed to balance potential benefits from less disclosure against costs in the form of lower share prices and increased threat of take-over and to choose the quality of disclosure which minimises the costs they incur. In this sense, disclosure quality is described by Verrecchia (1990) as the distributional characteristic or variance of an uncertain event. In this chapter, the researches is focusing on enhancing corporate stakeholders' confidence in the progress of the transition process taking into account the relatively high degree of uncertainty associated with this process. Therefore, corporate governance in transitional economies can by improved through monitoring corporate performance on the basis of improved and relevant disclosure arrangements.

5.5 Corporate Governance in Transitional Economies, Privatisation and Disclosure

Corporate governance in transitional economies is associated with the fact that the transition to a market economy could be readily achieved by privatising state-owned enterprises combined with introducing an equity market. The latter would serve as the market for corporate control which is an instrument for corporate governance and, hence, as an effective mechanism for raising the external finance much needed by privatised enterprises for their restructuring projects.

The most common consequence of the privatisation process in transition economies is the strong insider control by managers and workers.

Insider control has virtually blocked the development of an equity market (Aoki and Kim, 1995). The most observed characteristic is that managers (and employees under the ESOPs programs) are often conservative shareholders, reluctant to sell their shares for fear of loosing control. Moreover, industrial shares in insider-controlled enterprises are no longer attractive to potential investors because of low dividends and the virtual impossibility of obtaining large blocks of shares. Consequently, the equity markets tend to be thin and incapable of providing adequate finance for enterprise restructuring. Gray (1996) presents evidences from number of transition economies (such as Estonia, Hungary, Russia, Slovenia, Czech, Slovak Republics, and Poland) that show if the objectives of privatisation are to serve the links between the state and the enterprises, to school the population in market basics, and to foster further ownership change, the initial weight of evidence seems to favour significant reliance on voucher privatisation, especially given the difficulty most countries have finding willing cash investors. These insights, therefore, reveals the importance of more open disclosure arrangements and policies to strengthen investors confidence in the privatisation process.

It is clear that privatisation and, hence, the transition to a market economy, raises the question of how to make management accountable to shareholders and also to the requirements of law. Privatisation in transition economies gives rise the common issues - and also problems - of corporate governance in market economies such as the separation of ownership and control, the duties of directors, the need for disclosure given that separation, and the corporate charter as a vehicle for the direct participation of shareholders in governance. In this context, Klipper (1998) suggests that one of the best models of corporate governance that transition economies can use is that employed by the Leveraged-Buy-Out (LBO) and venture capital funds operating in the West which, in turn, necessitate more disclosure arrangements to corporate outsiders. Furthermore, Klipper (1998) recommends a greater entrenchment of law and economics in transition economies because both have greater impact than elsewhere. This is true as long as the institutional infrastructure in transition economies is not as strong as it is in the West.

As the emerging markets provided alluring investment opportunities by the beginning of 1980s, private capital did not hesitate providing the necessary financing to reap as much profits as possible. Most, if not all, of this capital has been flowing from the western countries. Considering that corporate governance has been always associated with corporate finance (Williamson, 1988), the inevitable outcome of the western financial flows was an inclusion of the western investment and corporate governance structure into different, and sometimes diverse, cultural and business practises (Staber and Aldrich, 1994). The western corporate governance structures favour the stock market as a readily institution for providing capital. Therefore, the western mode of corporate governance turned out to be characterised by 'short-termism' (Laverty, 1996) - the system that favours short-term outcomes over long-term sustainable ones - and it could not sustain good governance even for the stock market-driven economies (Bhide, 1994).

The aspects of the short-term corporate governance structures have been empirically examined in many works. For example, Hayes and

Abernathy (1980) focus on the fact that flawed management practice of discounting techniques to evaluate investment projects results in an undervaluation of the future. Kaplan (1984) highlights the fundamental weaknesses in the accounting model to increasing the reported profits while sacrificing the long-term economic health of the firm. Managerial opportunism is emphasised in the works of Narayanan (1985), Holmstrom and Ricart i Costa (1986) and Rumelt (1987) where they emphasise on managers' desire to invest in projects that offer faster profits and short paybacks to enhance their reputation and having their positions last as long as possible. In this sense, managers and shareholders as well are motivated to manage and monitor what can be readily measurable, e.g., changes in the stock prices and short-term profits per share (Lowenstein, 1996). The stock market myopia, which is the fundamental observable characteristic of the western investors' attitudes, is emphasised on the works of Loescher (1984), Stein (1988,1989), Johnson and Kaplan (1987) and Froot *et al.*, (1992). These works due the myopic investors' attitudes to the investors' eagerness to benefit from increases in the stock prices in the short-term, otherwise they would easily sell off their shares of stock as long as shares turned out to be traded as commodities. This can be true particularly when shareholders have neither the interest nor the knowledge to wait for the long run: this is what is so-called "impatient Capital" (Jacobs, 1991). In this regard, the uninformed and/or ill-informed traders in the stock market tend to manipulate as long as his/her trades are observable to only some traders in the market (Chakraborty, 1997).

Where uncertainty that characterises transitional emerging markets and the western corporate governance structures - e.g., short-termism, managerial opportunism, stock market myopia, fluid capital and impatient capital - joined with different cultures and commercial practises in transitional economies, the western governance structures do not appeal in most of the emerging markets. This has very important implications for both international investors and their business partners in transitional emerging markets as well. The need for coping with local business conditions gives arise to the need to seek more adaptable corporate governance structures rather than impose imported ones. An important discerning feature of the recent East Asian crises is the lack of monitoring mechanisms that can help to foresee the most adaptable path of corporate governance that helps to achieve sound economic growth. In this sense, transitional emerging markets can adopt an adaptable corporate governance system through monitoring corporate performance at the micro level that helps to achieve sound adaptable economic growth at the macro level. The considerable amount of uncertainty of the business environment in transitional emerging market and the resulted economic, social and political turmoil recently observed raise an important question concerning the most adaptable corporate governance structure(s) in these countries. As corporate governance structures stem from the institutional arrangements in a certain country, the transitional emerging markets are to examine and explore the most adaptable governance structures as long as the interaction between institutions and organisations shapes economic activity (North, 1996).

Commercial transactions in transitional economies tend to depend on personal relations. As a result, western companies may encounter difficulties penetrating markets dominated by the kinship-based business practices (Andrews, 1996). The personalities-based business conduct can easily lead to 'opportunism.' According to Williamson (1985a) opportunism '*...refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, obfuscate or otherwise confuse.*' Therefore, disclosure policies that reduce the quantity and quality of information increase the scope for opportunistic behaviour (Forker, 1992; Abrahamson and Park, 1994). This shows the importance for a company to explore monitoring techniques that can convey relevant and reliable information to its stakeholders, thus reduce the degree of uncertainty they encounter when evaluating corporate performance. Monitoring techniques are very important to transitional economies where high degree of insider control is observed. In this sense, insider control may encourage some aspects of opportunism as long as strategic decision making in the state-owned enterprises may reflect insiders' interests - for example, higher revenues from improved productivity might be distributed internally, perhaps as wage increases (Aoki and Kim, 1995; Vickers and Yarrow, 1988; Ramanadham, 1987).

5.6 Monitoring Corporate Transitional Performance: Theoretical Framework

The inclusion of the different modes of corporate governance into the emerging markets' business system has had very important implications concerning how corporate performance in transitional emerging markets is to be measured and monitored. Considering that privatisation, which is the most observed development path in transitional economies, does not necessarily provide a complete incur to corporate deficiencies (Hemming and Mansour, 1988), corporate performance should be monitored through wider measurements.

Although the works of Garten (1997a,b), Lee, *et al.,* (1998), Andrews (1996), Fischer and Gelb (1991), Peng (1993, 1994), Xin and Pearce (1994), World Bank: Directions in Development (1997), Khanna and Palepu (1997a,b), Kuznetsova and Kuznetsov (1998), Pannier (1996), Lieberman *et al.*, (1997) and Guislain (1997) emphasise on the different political, economic and social aspects of the transitional economies, there is a general scarcity in transitional economies research that explores and utilises quantitative models to structure some of the dominant factors in these economies. Therefore, the approach of this chapter takes a new research rout through which a statistical model is built to formalise some of the underlying dominant factors that shape the structure of corporate governance in emerging economies in transition.

The existing literature on the measurements of the competition-driven corporate performance tells that western firms are motivated to grow according to number of strategic choices to achieve growth (Child, 1972, 1994). In this regard, it is worth to examine whether those strategic choices, and the resulted measurements of corporate performance, are relevant to transitional emerging markets (Boyacigiller and Adler, 1991; Williamson, 1991; Peng, 1993, 1994; Peng and Heath, 1996). To select an appropriate corporate strategy requires top management to inventory the internal strengths and weaknesses of the organisation as well as to evaluate the opportunities and constraints the business environment presents (Child, 1972; Porter, 1980; Chandler, 1996). Therefore, companies in transitional emerging markets are to be monitored on the basis of their ability to reflect a strategic adaptable and sustainable performance. Considering that there are a wide range of aspects of strategic performance, the aspects that should be adopted are the ones that enhance the business confidence in a stage of transition. In this respect, the aspects that reflect the firm's transformation ability and those that enhance the business confidence should be adopted. The measurement of corporate performance has been examined in different studies throughout the literature of finance, strategic management and international business. Considering that there is little agreement on how strategic performance should be measured (Cameron and Whetten, 1983; Goodman, 1979; Hannan and Freeman, 1977), this necessitates to rely on the literature of finance, corporate strategy and international business altogether to outline broader course of measures of company performance that can be used in the case of emerging countries in transition.

5.6.1 Corporate Financial Performance

As for the literature of finance, measures of corporate performance rooted in financial accounting have come in for a lot of recent criticism. The problems that have been cited with this approach are: (1) scope for accounting manipulation; (2) undervaluation of assets; (3) distortions due to depreciation policies, inventory valuation and treatment of certain revenue and expenditure items; (4) differences in methods of consolidating accounts, and (5) differences due to lack of standardisation in international accounting conventions. Moreover, accounting measures of performance record only the history of a firm.

As the **Z**-score model has been primarily used in the literature of corporate finance to predict bankruptcy (the **Z** values are essentially constructed to predict bankruptcy). It can also used as an index of the company's overall well-being. The higher the **Z** value is beyond 3, the more healthy is the firm. By measuring distance from bankruptcy, **Z** factor could be a surrogate index of strategic performance. Nevertheless, this measure is obviously flawed in that a well-managed firm does not focus all its energies only on staving off bankruptcy (Chakravarthy, 1986). In addition, the report of the Royal Society of Arts (1995), is pointing out that of the eleven companies named Britain's most profitable by *Management Today* between 1979 and 1989, four subsequently collapsed and two were acquired, the report identifies one of the main obstacles to the United Kingdom competitiveness to be 'over-reliance on financial measures of performance.' Monitoring firm's strategy requires measures that can also capture its potential performance in the future (Carroll, 1979). An empirical evidence suggests that conventional referents of performance, whether they be measures of profitability or financial market measures, for example like the 'market/book ratio' (M/B ratio), are unsatisfactory discriminants of 'excellence.' For example, Chakravarthy (1986) has applied a profitability ratios as measures of strategic performance and found that none of those ratios are capable of distinguishing between 'excellent' firms from 'non-excellent' ones. As for the (M/B) ratio, it is not possible to give a credible and sustainable results in the case of the companies in emerging countries in transition. The reason is that the stock markets in these countries, especially in a stage of transition, are not efficient enough to reflect a true market value. In addition, this ratio is not entirely free from accounting manipulations, so the book value of a firm can be distorted. Therefor, Chakravarthy's study concluded that financial and stock market measures of performance have at least three major limitations: (1) they assume that a single performance criterion can assess excellence; (2) they focus only on outcomes to the exclusion of transformation processes within the firm, and (3) they ignore the claims of other stakeholders besides the stockholders. In sum, financial ratios (or broadly tools of financial analysis) reflect only the ultimate financial profile of a company rather than the links between and among the company's various activities including the financial activities. In addition, from a strategic point of view, we should focus on the other company activities as much as possible to find out the important cornerstones that eventually lead to financial outcomes (Wallman, 1995). By focusing on the company's activities, managers will have a good chance to develop a broader view to analyse and find out the points of strengths and/or weaknesses in the company strategies. Although external financial reports are generally prepared on a going concern basis, the financial information solely can not reflect and predict company's long-term capabilities and strategies that should, or should not, be adopted to ensure long-term sustainable performance. The latter requires a more broader perspectives which incorporate number of variables that reflect, as much as possible, the basic activities of a company.

Accordingly, there is an agreement to use number of financial ratios that show company's aggregate financial profile, such as ROCE (Return On Capital Employed), Profit Margin and Asset turn (Eilon, 1988; Weston and Brigham, 1993; Damodaran, 1997). Buzzell *et al.*, (1975) state that company's market-share position is widely believed to be a determinant of profitability and, therefore, would be a meaningful indicator of performance. Van Horne (1989) and Van Horne and Wachowicz (1995) provide a model of 'Sustainable Growth Rate' which can be used effectively to monitor a company's financial growth. In addition, company's financial autonomy is measured by a number of proxy measures of financial transformation such as Market-oriented Financial Discipline and Transparency in Financial Relations (Ayub and Hegstad, 1987; Hemming and Mansour, 1988). In addition, some inventory and capacity utilisation-related measures are used to monitor the functional aspects of an industry and/or a company (McTigue, 1993).

5.6.2 Corporate Strategic Performance

The literature of corporate strategy provides a variety of measures that explore and examine company's business strategies. Chakravarthy (1986) suggests number of measures to monitor company's transformation process. Nevertheless, it should be noted that Chakravarthy has ignored measures that are related to "market position" and "growth in sales and market share" because they are not readily available for all businesses. Lev (1992) suggests corporate information disclosure strategy that helps deterring political and regulatory intervention and, at the same time, avoids misperceptions by non-investors stakeholders. Venkatraman and Ramanujam (1986), McGuire

(1983), Taffler (1981, 1983, 1995) and Prahalad (1993) combine insights from both of the literature of finance and corporate strategy by using the ratio of corporate Value added/Average Total Assets as a measure of corporate financial performance.

5.6.3 Measures of Corporate Governance

As for the literature of corporate governance, number of works focus on the financial phase of the governance process: the phase that shows the effects of corporate financial structures on managers reaction and, eventually, on corporate performance. As most of the Anglo-Saxon corporate governance mechanisms are not viable to transitional emerging markets, the researcher focuses on the basic governance structures: those that emphasise the relative importance of governmental, banking and foreign financing (Triantis and Daniels, 1995; Carney, 1997; Borish *et al.*, 1995; Kim, 1995; Kaplan, 1997; Macey and Miller, 1995; Phelps, *et al.*, 1993). Hoskisson and Turk (1990), Grier and Zychowiccz (1994), Aoki and Kim (1995) and Pannier (1996) combine the literature of corporate governance and corporate strategy to provide proxy measures of alternative modes of corporate governance. In terms of international business systems, these measures are very useful for transitional emerging markets as long as the process of the transition itself involves examining and re-examining alternative modes of governance so as to adopt what is (are) relevant for each country according to the county-specific characteristics of its economic, political and social infrastructure (Hillman and Keim, 1995; North, 1996).

5.6.4 Company's International Transitional Performance

The literature of international business provides some measures of the process of internationalisation that are helpful in the cases of emerging countries in transition (Aggarwal and Agmon, 1990; Sullivan, 1994, 1996; Ramaswamy and Kroeck, 1996; Ellis, 1998; Ietto-Gillies, 1998). In general, these measures focus on the role of exports as a stage of country and/or company internationalisation process. Porter's works, by providing some measures of company's competitiveness, incorporate some insights from the literature of finance, corporate strategy and international business to highlight some aspects of a company's competitiveness (Porter, 1980, 1985). In addition, a standardised measure of risk is included as a measure of risk (Van Horn, 1977, 1989; Van Horne and Wachowicz, 1995).

The above literature is very helpful to provide a variety of first-order measures that can help examining and monitoring corporate transitional performance in emerging markets, taking into account that the literature of measuring corporate transitional performance quantitatively is relatively new. In addition, these measures are to give company's stakeholders a realistic information concerning the extent of its progress in the stage of transition. This can eventually enhace the company's identity in the market place. Accordingly, number of meaningful ratios are used to build a Z-score model for monitoring corporate transitional performance in Egypt.

5.7 Egypt as a Transition Economy

The Open Door Policy in Egypt initiated in 1974 encouraged private investment. The contribution of the private sector rose from 10 per cent of total investment in 1973 to 24 per cent in 1981. It accounted for 48 per cent of the GDP in 1981-1982 (The Five-Year- Plan's Pillars and Policies, 1982/83-1986/87). More insights regarding private investments are shows in table (5-1).

Table (5-1): Private investment in Egypt*

Sector	Private investment as % of total investment		Change %
	1977-82 Plane Period	1982-87 Plan Period	
Agriculture and land reform irrigation and drainage	29	27	-6.89
Industry and Military	23	21	-8.69
Petroleum	-	-	-
Electricity	-	-	-
Contracting	24	54	125
Total Commodity Sector	20	20	0
Transport and Communication	3	6	100
Suez Canal	-	-	-
Commerce, Finance, Insurance, and Tourism	14	33	135.71
Total Production Service Section	5	8	60
Housing	74	94	27.03
Public Utilities	-	-	-
Education, Health, other services	16	26	62.5
Total Services Sector	36	45	25
Total Fixed Investments	20	23	15

* Source: The Five-Year- Plan's Pillars and Policies, 1982/83-1986/87. Part One - The Present (Cairo), p. 63.

The Open Door Policy involved a variety of administrative and legislative measures. Law No. 43 of 1974 concerning the Investment of Arab and Foreign Funds and the Free Zones, as amended by Law No. 32 of 1977, states that *"projects may not be nationalised or confiscated... except by judicial procedures"* (Article 7) and offers the enterprises several privileges and exemptions. The companies coming under this law are deemed to belong to the private sector; and legislation and regulation applicable to the public sector do not apply to them. For example, the conditions and procedures for electing labour representatives to the board of directors of public sector enterprises do not apply to them except that the companies' own statutes shall provide for labour participation in management by some method (Article 10). Employees and board members are exempted from the provisions of Law No. 113 of 1961 that limits remuneration (Article 11).

Furthermore, the projects of the enterprises are exempted from a variety of taxes (under article 16 and 17). Under Article 6 enterprises established *"entirely with Egyptian capital and owned by Egyptian nationals"* also enjoy many of the above-cited privileges. Joint ventures involving foreign capital can be so organised as to allow *"majority foreign ownership and management control,"* with one exception, viz. banks, where the Egyptian share should be at least 51 per cent (CitiBank, 1988).

There have been other elements of privatisation in government policies. As regards the enterprises that stay in the public sector, the government has established new policies in two important directions.

1. The managers are provided with a greater degree of autonomy that before. In this regard, Handoussa (1980) refers to the measures of decentralisation in control over public enterprises with the abolition of the General Organisation, which were analogous to holding companies, and to the granting of some autonomy to managers in the areas of employment, wage payments and pricing.
2. The government has determined that there was no alternative to a careful cost-benefit analysis of every project, to ensuring efficient implementation of investment at the lowest costs possible, to the choice of efficient

technical and management systems, and to the reducing of losses at every stage of the production process (Ramanadham, 1987). The Plan document (1982-87) is replete with such desiderata as *"reconsidering the management of the public sector to raise its productivity,"* reducing subsidies, fixing prices on *"economic basis,"* and *"fixing a remunerative price that ensures a reasonable rate of profit enough to finance investment."* (The Five-Year- Plan's Pillars and Policies, 1982/83-1986/87).

The empirical part of this paper is applied to the Egyptian Textile Sector. According to the World Bank categories, Egypt is not categorised as one of the Big Ten emerging markets and, at the same time, is not one of the less developed countries any more. The Egyptian government started the privatisation program and trade liberalisation by the end 1991 to take part of the global economy. As most of the reform programs are in process, Egypt can be considered an country in transition. Therefore, there is a need for the Egyptian companies, and other companies in the same economic position as well, to monitor its path of transition.

5.8 Monitoring Corporate Transitional Performance: An Empirical Evidence

5.8.1 Research Variables

As mentioned above in the theoretical framework, the literature of finance, corporate strategy, corporate governance and international business result in number of ratios that are useful in monitoring transitional corporate performance. Thirty one ratios are emphasised upon in the literature and, therefore, considered appropriate to the nature of the study. A list of these ratios is provided in Appendix (5-1). To address the problem of multicollinearity between and among those variables and to avoid its effects on the final results, a correlation analysis is carried out and the correlation matrix is provided in Appendix (5-2). As a result, seven out of the thirty one variables were excluded from the analysis as their associated coefficients of correlation are very high.

5.8.2 Data Normality

For testing the normality of the data, a 'chi-square goodness of fit' (χ^2) test is carried out for each of the variables used in the study. The results are shows in table (5-2).

Table (5-2): The statistical results of χ^2 test of the variables of corporate transitional performance[1]

Variable	*p*-value	Variable	*p*-value
BF/TF	0.061	**Imp/Exp**	0.053
COC	0.058	**IWC**	0.073
CU	0.052	**RDP**	0.003
Exp/I Exp	0.06	**R&D/S**	0.051
Exp/S	0.056	**SGR**	0.054
FC	0.071	**S/TC**	0.09
FCCP	0.052	**Std**	0.054
FD/TF	0.05	**S/TM**	0.001
GF/TF	0.074	**TEG**	0.051
GMS	0.062	**VA/ATA**	0.06
GTIPF	0.08	**VQE**	0.062
IF/TF	0.063	**WC/S**	0.055

The results in table (5-2) show that only two variables out of the twenty four variables are not normally distributed (*p*-value< 0.05). This means that 91.67% of the data is normally distributed.

[1] The χ^2 test is carried out at the significance level 95%.

5.8.3 Data Validity

5.8.3.1 *Content and construct validity*

As the variables used in this study are drawn from relevant literature that adequately provides a multi-dimensional perspectives for measuring corporate performance, the variables are considered an adequate coverage of the important content, therefore, they provide a good basis for content validity (Nunnally, 1978). In addition, as the variables have been empirically examined in other related studies in the literature of finance, corporate strategy, corporate governance and international business, they provide an adequate evidence of construct validity.

5.8.3.2 *Discriminant validity*

To test for discriminant validity (Podsakoff, and Organ, 1986) and, at the same time, to address the issue of the dimenionality of the twenty four ratios that are basically drawn from various literature, another multivariate technique, the Principal Component Analysis (PCA - varimax rotated), is carried out. The object of the analysis is to take a number of variables and find combinations of these to produce indices, i.e., factors that are uncorrelated. The lack of correlation is a useful property because it means that the factors are measuring different dimensions in the data (Manly, 1998; Hair *et al.*, (1995). Therefore, PCA is used to reduce the dimensionality of the data set. That is, the original data variables are projected into new axes such that the new variables, orthogonal to each other and thus uncorrelated, are linear combinations of the old (Taffler, 1981). The decision to include a variable in a factor was based on factor loadings greater than 0.50 and all factors whose eigenvalue was greater than one were retained in the factor solution. (Tabachnick and Fidell, 1989; Hair *et al.*, 1995). The results of the PCA analysis are shown in table (5-3).

Table (5-3): The Principal Component Analysis (PCA-varimax rotated)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6	Factor 7	Factor 8
BF/TF		0.65						
COC					0.90			
CU							0.55	
Exp/I Exp				0.74				
Exp/S							0.68	
FC						0.76		
FCCP	0.58							
FD/TF	0.53							
GF/TF		0.80						
GMS			0.81					
GTIPF					0.80			
IF/TF	0.74							
Imp/Exp				0.91				
IWC						0.71		
RDP							0.72	
R&D/S								0.72
SGR								0.80
S/TC	0.64					0.54		
Std	0.80							
S/TM			0.71					
TEG				0.84				
VA/ATA	0.81							
VQE			0.61					
WC/S						0.84		
Eigenvalue	5.20	2.94	2.78	1.98	1.70	1.45	1.37	1.16
Percentage of Variance	21.7	12.3	11.6	8.3	7.1	6.00	5.7	4.9
Reliability Analysis								
alpha	0.55	0.66	0.70	0.70	0.79	0.51	0.51	0.77
F-Ratio	14.06*	4.47**	215.3*	4.75*	28.57*	52.8*	287.3*	4.34**

* Significant at the significance level 99%.

** Significant at the significance level 95%.

Table (5-3) shows a summary of the results of the Principal Components Factor Analysis. It also shows that the dimensionality of the twenty four variables could be reduced to eight dimensions. That is, the variables are loaded on eight factors that describe eight aspects of companies' transitional performance. The eight factors accounts for 77.6 per cent of the explained variance.

5.8.4 Data Reliability

A Reliability Analysis is carried out for each factor (Churchill, 1979; Nunnally, 1967). The results in Table (5-3) show an acceptable *Alpha* coefficients for each factor. Although three of the coefficients, range from 0.51 to 0.55, may be relatively low, they are acceptable considering that: (1) the combination of the variables used in this study is new; (2) the research instrument, the application of the Z-score model in the field of international business in emerging countries in transition is new, and (3) the relatively high volatility in the business environment in emerging countries in transition affects the available data with some degree of noise or irregulatory.

5.8.5 Dimensionality of the Variables

The Principal Component Factor Analysis has resulted in loadings of the twenty four variables on eight uncorrelated factors. Although each factor includes various, and perhaps different, variables that emphasise more than on dimension of corporate transitional performance, the factors could be readily interpreted as it is shown in Table (5-4).

Table (5-4): Dimensions of corporate transitional performance

Factor	Variables	Dimension
Factor 1	• Foreign Component in a Company's Portfolio (FCCP) • Internal Financing/Total Financing (IF/TF) • Sales/Total Capital (S/TC) • Standardised measure of risk (Std) • Value Added/Average Total Assets (VA/ATA) • Foreign Debt/Total Financing (FD/TF)	Viability of Financial Transformation
Factor 2	• Banking Finance/Total Finance (BF/TF) • Governmental Finance/Total Finance (GF/TF)	Proxy Measures of Alternative corporate Governance Structures
Factor 3	• Growth in Market Share (GMS) • Sales/Total Employees (S/TM) • Variations in the availability of Qualified Employees (VQE)	Company's Relative Market Position
Factor 4	• Imports/Exports (Imp/Exp) • Total Exports Growth (TEG) • Exports/ Industry Exports (Exp/I Exp)	Company's Position in the Process of Internationalisation
Factor 5	• Cost of Capital (COC) • Growth in Total Investments in Production Facilities (GTIPF)	Inputs of Company's Competitive Position
Factor 6	• Foreign Component (FC) • Inventory Weeks of Consumption (IWC) • Sales/Total Capital (S/TC) • Working Capital/Sales (WC/S)	Company's Strategic Aspects of Investing Slack Resources
Factor 7	• Capacity Utilisation (CU) • Exports/Sales (Exp/S) • Rare of Defected Products (RDP)	Degree of Success in Foreign Markets
Factor 8	• R&D/Sales (RDS) • Sustainable Growth Rate (SGR)	Proxy Measures of Management of Innovation

5.8.6 Empirical Results

5.8.6.1 The drived Z-score model

Using a stepwise selection algorithm, it was determined that four variables were significant predictors of grouping. The one discriminating function with *p*-value less than 0.05 is statistically significant at the 95% significance level. The discriminant function with its standardised coefficients is as follows.

$$\mathbf{Z} = 1.07\ \mathbf{GF/TF} + 1.24\ \mathbf{BF/TF} + 0.76\ \mathbf{COC} - 0.63\ \mathbf{Std}$$

Where **Z** = Overall score

GF/TF = Governmental Finance/Total Finance

BF/TF = Banking Finance/Total Finance

COC = Cost of Capital

Std = Standardised measure of risk

As the two groups are not in equal size, the model can be used operationally by taking into account the prior probability estimates of each group (Taffler, 1983, 1995). The prior probability ratio is an estimate of the proportion of companies with a ratios profile more similar to that of group 1 (the privatised companies) and a ratios profile more similar to that of group 2 (the non-privatised companies). The estimated prior probability ratios are 0.23 for group 1 and 0.77 for group 2, resulting in a cut-off point of -1.21 on the **Z**-Scale. Since the actual variable measurement units are not all comparable to each other, simple observation of the discriminant coefficient is misleading. Therefore, the final four variables profile is to show the relative contribution of each variable to the total discriminating power of the **Z**-score model, and the interaction between them. The common approach used to assess the relative contribution is based on measuring the proportion of the Mahalanobis **D**^{2} -distance between the centriods of the two constituent groups accounted for by each variable according to the following formula (Mosteller and Wallace, 1963; Taffler, 1981, 1983):

$$P_j = \frac{c_j\left(\bar{r}_{jf} - \bar{r}_{js}\right)}{\sum_{i=1}^{4} c_i\left(\bar{r}_{if} - \bar{r}_{is}\right)}$$

Where

P_j = The proportion of the D^2 -distance accounted for by ratio j

$\bar{r}_{if}$ and $\bar{r}_{is}$ = The means of the privatised and non-privatised groups for ratio i respectively.

Table (5-5): Dimensions of the **Z**-model of corporate transitional performance

Variable	**Dimensions of Transitional Performance**	**Relative Contribution* %**
Banking Finance/Total Finance (**BF/TF**)	Proxy Measures of Alternative Corporate Governance Structures	33.51
Governmental Finance/Total Finance (**GF/TF**)		28.92
Cost of Capital (**COC**)	Inputs of Company's Competitive Position	20.54
Standardised Measure of Risk (**Std**)	Viability of Financial Transformation	17.03
		100

* Mosteller-Wallace measure.

The results in Table (5-5) indicate that the ratio of Banking Finance/Total Finance (**BF/TF**) accounts for proportionally high percentage of the total discriminatory power of the model, the next important variable is the ratio of Governmental Finance/Total Finance (**GF/TF**), then the company's Cost of Capital (**COC**) and the last variable that accounts for the rest of the discriminatory power is the Standardised measure of risk (**Std**).

5.8.6.2 The Accuracy-Matrix of the drived Z-score model

In the multi-group case, a measure of success of the discriminant analysis is to be carried out. The results are shown in a classification table or "Accuracy-Matrix," as shown in figure (5-6) (Altman, 1968).

Actual Group Membership	Predicted Group Membership	
	Privatised	Non-privatised
Privatised	**H**	$\mathbf{M}_1$
Non-privatised	$\mathbf{M}_2$	**H**

Figure (5-6): The Accuracy-Matrix of the discriminant analysis

The actual group membership is equivalent to the a priori groupings and the model attempts to classify correctly these companies. At this stage, the model is basically explanatory. When new companies are classified, the nature of the model is predictive. The **H**'s stand for correct classifications (Hits) and the **M**'s stand for misclassification (Misses). $\mathbf{M}_1$ represents a Type **I** error and $\mathbf{M}_2$ represents a Type **II** error. The jack-knife test, or *Lachenbruch Holdout Test*, (Lachenbruch, 1967) is the readily statistical test for carrying out the classification table. The final results of the jack-knife test are shown in table (5-6). Therefore, Type **I** and Type **II** can be easily observed according to the "Accuracy-Matrix" shown in figure1. Type **I** = 0%, and Type **II** = 8.33%. In this sense, the low values of Type **I** and Type **II** errors support our confidence in the *Alpha* coefficient of the Reliability Analysis (Bagozzi *et al.*, 1991).

Table (5-6): *Lachenbruch Holdout Test* (jack-knife test)

Actual Group Membership	No. of cases	Predicted Group Membership*	
		Privatised	Non-privatised
Privatised	7	7 100.0%	0 0%
Non-privatised	24	2 8.3%	22 91.7%

* Percent of "grouped" cases correctly classified: 93.55%. The output of the final results and the disriminant scores of each company in the sample are presented in Appendix (5-3).

5.8.6.3 The drived Z model's Accuracy of Prediction

The accuracy of prediction can be carried out by two common and practical tests: the first is to be done through *secondary sample of privatised companies*, and the second is to be done through a *secondary sample of non-privatised companies*. The essence of the two tests is to trace changes on Type **I** and Type **II** errors respectively. As for the first test, fortunately Table (5-6) shows that the drived **Z** model is hundred per cent accurate in predicting the number of the privatised companies: Type **I** error literally does not exist at all. This result is very accurate as long as the privatised companies are seven companies, the same as the actual number of the privatised firms. When Type **I** error does exist, it is very sensible to test the degree of its accuracy.

As for Type **II** error, the second test is carried out by choosing the non-privatised companies to test for the prediction accuracy of the model in classifying those companies. The grouping of the twenty four companies is based on matching the size and market share of the initial privatised companies used in the drived model. Nine companies did match the size and market share of the initial privatised companies. The results of the *jack-knife* test of the twenty four companies are shown in Table (5-7).

Table (5-7): *Lachenbruch Holdout Test* (jack-knife test) [Accuracy of Prediction]

Actual Group Membership	No. of cases	Predicted Group Membership*	
		Privatised	Non-privatised
Privatised	9	6 66.67%	3 33.33%
Non-privatised	15	4 26.67%	11 73.33%

* Percent of "grouped" cases correctly classified: 70.83%.

Table (5-7) shows that the discriminant model correctly classified 73.33% of the non-privatised companies as actually non-privatised. The high overall correction classification of 70.83% is another indicator of the degree of accuracy of prediction. In fact, when the actually privatised companies are taken into account, Type **II** error decreases to only 8.3%. This is good indicator of the accuracy of prediction of the drived **Z**-score model.

The model developed in this chapter adds an additional scope to the development and usage of these models by the inclusion of a substantial number of corporate transformation-specific ratios. These ratios emphasise on very important dimensions specially for the transitional emerging markets. These dimensions enhance the credibility and validity of the business strategies adopted in these markets. That is, after the transitional-specific ratios are included, the resulted model illustrates the multi-dimensional nature of the process of corporate reform.

The final outcomes of a transitional-based **Z**-model are to be viewed as strategies that need a major concern from both top management and public policy makers. Thus a continuos development of transitional-based **Z**-models helps to clear out the strategies and priorities that should be of major concern. In this regard, Table (5-4) shows that the most important dimensions are the Alternative Structures of Corporate Governance, Inputs of Company's Competitive Position and Viability of Financial Transformation, respectively. As for the first dimension, it emphasises on the conventional alternative corporate governance structures: bank financing governance and/or government financing governance. This dimension is considered as a matter of reality in the transitional markets, where the financial structures of the companies combine both of these two types of governance. Considering that markets in transitional emerging countries are imperfect, the use of the **Z** models for corporate monitoring in these countries can help reducing monitoring costs and information costs. This helps, *inter alia,* bring about good governance by corporate constituencies who are interested in corporate reform in transitional emerging markets.

As for the second dimension, factor 5 in Table (5-3) indicates some of the well-known inputs for building a competitive position: Cost of Capital and Growth in Total Investment in Production Facilities. This means that the lower the first variable and the higher the second one, the higher the competitive position of a company that is getting ready to compete publicly.

As for the last dimension, factor1 in Table (5-3) shows that Foreign Component in a Company's Portfolio, Standardised Measure of Risk and Foreign Debt/Total Finance are the most important variables in monitoring the Viability of Financial Transformation. This literally means that privatisation is not a matter of capital transfer and/or capital restructuring as long as this process is associated with some degree of risk. If the latter is high, the privatisation process is expected to be very slow, and vice versa. This conclusion is of great importance to the transitional emerging markets as the recent crises in the emerging markets in East Asia should encourage public policy makers to establish well-adaptable institutional infrastructures that can reduce the degree of risk associated with the process of transition (Peng, 1993, 1994; Lee, *et al.*, 1998).

5.9 Conclusion

As this chapter is benefiting from the insights provided by the literature of finance, corporate strategy, corporate governance and international business, it can be considered as an extension to the literature that incorporates the international, corporate and business research levels (Dess *et al.*, 1995). Accordingly, as the **Z**-model is built using a variety of measures that demonstrate the financial, operational, and competitive phases of a company, the model then can be used conveniently to monitor the transitional performance of a public enterprise (PE) in the transitional economies.

The monitoring aspect of the **Z**-score model is important to transitional economies as a study in corporate governance in transitional economies (Pannier, 1996), indicates that corporate governance reform of public enterprises in transitional economies should enable the injection of transparent rules and procedures instead of direct and personal interventions, and protects public assets from undue appropriation by insiders. As an evidence, recent studies show that improved corporate governance is particularly important in the transitional economies because the institutional infrastructure are not strong enough to provide fair measures of monitoring corporate performance (Lieberman *et al.*, 1997; Guislain, 1997). Accordingly, other measures that provide checks on the behaviour of managers, such as rating companies, brokers, financial investors that assess the performance of enterprises and the capital market are yet to develop. From a public policy point of view, there has also been an intense debate on the role of state and national competitiveness in the age of global competition. Acknowledging the growing force of globalisation, Dunning (1996) and Porter (1990) discuss the role of the state in enhancing the competitiveness of national industries. This, once again, emphasises on the role of public policy makers in adopting policies that enhance the viability of financial transformation and companies' competitive position. Therefore, the public sector in transitional countries can help in emerging, rather than submerging, these countries' distinctive capabilities. In addition, the model shows that privatisation is not the only option or mode of transition as the governmental financing and banking financing relative contribution are observed. The ultimate benefit from the development and the use of transitional-based **Z** models is to provide market indices which can help in allocating resources efficiently (Choi, 1997).

As the in-depth quantitative research in emerging economies is relatively new, it is constrained by the availability of data, the development strategies adopted by the governments and the degree of success those economies could realise. Therefore, further research can be carried out in other emerging economies to build **Z** models for monitor the degree of convergence, or divergence, between and among emerging countries, and between emerging economies and the other two business systems, the Anglo-Saxon system and Communitarian system. Although the **Z** model does not capture the qualitative or the behavioural aspects of a business system, the components of the model must be regarded as the first-order mechanism for monitoring corporate observable and measurable quantitative, rather than hard-to-measure qualitative, performance.

CONCLUSION OF PART TWO

Part two examined three interrelated issues in corporate governance. Specifically, the results show that banks are to be considered good monitors of corporate orientation towards stakeholders interests including shareholders interests. In this sense, corporate stakeholders can be considered active "Drivers of Identity," that help the company to strengthen its relative competitive position in the marketplace. This necessitates the company to release some relevant information their stakeholders, so to help them certify its relative competitive position. This is examined by building **Z**-Score model for monitoring corporate performance.

PART THREE

CONCLUSION OF THE STUDY AND FUTURE RESEARCH

Conclusion of the study

This study has explored the differences between the international corporate governance modes on the basis of their inherent institutional infrastructure that entails a certain mode to be preferable over others. In this sense, the differences between and among the international corporate governance modes are mainly due to differences in the institutional orientations rather than the differences in corporate governance practices.

On that basis, this study examined three issues that can be considered premises for addressing any institutional changes specially in emerging markets. Furthermore, the important conclusion that can be drawn from this study is the strong link between the financial and non-financial aspects of corporate governance which ultimately leverage corporate competitiveness in an age of diminishing business/country boundary.

Taking into account the institutional infrastructure in emerging markets, the financial and non-financial aspects of corporate governance are to be considered when the economic institutions in emerging markets are adaptable and mature enough to perform business transactions without having to incur drastic economic and/or social pitfalls that may go against enhancing company/country competitiveness.

Future Research

There are some work that can be done in the future to extend the issues examined in this study. They are as follows.

1. The issue of shareholders versus stakeholders orientation

Further research is warranted on the following two areas. Firstly, a more in depth analysis of the strengths and weaknesses of banking in stakeholder and shareholder within the same country. Secondly, to analyse whether the inherent collectiveness of stakeholder systems can lead to difficulties of adjustment to rapid globalisation and dramatic change.

2. The issue of corporate identity

This issue is examined in banking industry as an example of the financial services industries which is characterised by product intangibility. Further research can be carried out in other industries which is characterised by product tangibility. The comparison between the two cases will add new insights to the issue of corporate identity as an additional governance structure.

3. The issue of monitoring corporate transitional performance.

This issue is basically applied to Egypt as an example of transitional emerging countries. This idea can be further developed in other emerging market not only the transitional markets but also the markets that have already been emerged such as the Ten Big Emerging markets of which some of them are recently facing institutional instability.

APPENDICES

Appendix (3-1): The correlation matrix of the dependent variables (banks performance measures)[2]

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	Y11	Y12	Y13
Y1	1.00												
Y2	0.38	1.00											
Y3	-0.35	-0.22	1.00										
Y4	-0.42	-0.15	0.85	1.00									
Y5	-0.41	-0.19	0.97	0.91	1.00								
Y6	-0.13	-0.03	0.13	0.14	0.12	1.00							
Y7	-0.15	0.12	0.20	0.21	0.21	0.36	1.00						
Y8	0.22	0.16	-0.29	-0.19	-0.32	0.42	0.53	1.00					
Y9	0.02	0.27	-0.25	0.07	-0.16	0.14	0.17	0.24	1.00				
Y10	0.06	0.27	-0.27	0.05	-0.17	0.11	0.15	0.22	0.98	1.00			
Y11	0.25	0.94	-0.14	-0.08	-0.09	-0.09	0.10	0.03	0.28	0.28	1.00		
Y12	-0.37	-0.80	0.17	0.08	0.11	0.21	0.05	0.07	-0.25	-0.27	-0.88	1.00	
Y13	-0.38	-0.84	0.21	0.12	0.15	0.20	0.04	0.05	-0.27	-0.28	-0.91	0.38	1.00

Appendix (3-2): List of the banks in the study

No	BANK
1.	BANQUE NATIONALE DE PARIS PLC
2.	WOODCHESTER CREDIT LYONNAIS PLC
3.	YAMAICHI BANK (UK) PLC
4.	ABC INTERNATIONAL BANK PLC
5.	LLOYDS TSB GROUP PLC
6.	MIDLAND BANK PLC
7.	NATIONAL WESTMINISTER BANK PLC
8.	NORTHERN BANK
9.	YORKSHIRE BANK PLC
10.	ROYAL BANK OF SCOTLAND PLC
11.	NATIONAL AUSTRALIA GROUP (UK) LTD
12.	TSB BANK SCOTLAND PLC
13.	ULSTER BANK LIMITED
14.	BARCLAYS BANK PLC
15.	TOKAI BANK EUROPE PLC
16.	CITIBANK INTERNATIONAL PLC
17.	BANK OF AMERICA INTERNATIONAL LTD
18.	ITALIAN INTERNATIONAL BANK PLC

[2] Y1 = Net Interest Income/Total Revenue, Y2 = Operating Income/Total Assets, Y3 = Liquid Assets/Total Assets, Y4 = Liquid Assets/Deposits, Y5 = Liquid Assets/Deposits & Borrowing, Y6 = Non-performing Loans/Total Loans, Y7 = Reserves/Gross Loans, Y8 = Provisions/Gross Loans, Y9 = Shareholders Equity/Total Assets, Y10 = Capital Funds/Total Assets, Y11 = ROI, Y12 = World Ranking (According to Return on Assets), Y13 = Country Ranking (According to Return on Assets).

19.	NOMURA BANK INTERNATIONAL PLC
20.	3I GROUP PLC
21.	FIRST NATIONAL BANK
22.	COMMERZBANK
23.	BANK OF NEW YORK
24.	WHITEAWAY LAIDLAW BANK
25.	CLYDESDALE BANK PLC
26.	BRITISH ARAB COMMERCIAL BANK LIMITED
27.	ABBEY NATIONAL TREASURY SERVICES
28.	CO-OPERATIVE BANK PLC
29.	LAZARD BROTHERS & CO. LIMITED
30.	TOKYO-MITSUBISHI INTERNATIONAL PLC
31.	CLIVE DISCOUNT COMPANY LIMITED
32.	CHARTERHOUSE BANK LIMITED
33.	WEST MERCHANT BANK HOLDINGS LIMITED
34.	CATER ALLEN HOLDINGS PLC
35.	DAIWA EUROPE BANK PLC
36.	HMC GROUP PLC
37.	KLEINWORT BENSON LTD
38.	ANZ INVESTMENT BANK PLC
39.	MERRILL LYNCH INTERNATIONAL BANK LIMITED
40.	CAPITAL BANK PUBLIC LIMITED
41.	ROYAL BANK OF CANADA EUROPE LIMITED
42.	SCHRODERS PLC
43.	STANDARD CHARTERED BANK PLC
44.	BANKERS TRUST INTERNATIONAL PLC
45.	YASUDA TRUST AND BANKING CO. LTD
46.	BANK OF SCOTLAND
47.	J. HENRY SCHRODERS & CO LIMITED
48.	COUTTS & CO.

Appendix (3-3): Correlation matrix of Banks–Corporate Stakeholder Orientation (the dependent variable is Profitability measures)[3]

```
Correlation matrix for coefficient estimates
-----------------------------------------------------------------------
                          CONSTANT            fx2
CONSTANT                    1.0000        -0.3870
fx2                        -0.3870         1.0000
-----------------------------------------------------------------------


The StatAdvisor
---------------
   This table shows estimated correlations between the coefficients in
the fitted model.  These correlations can be used to detect the
presence of serious multicollinearity, i.e., correlation amongst the
predictor variables.  In this case, there are no correlations with
absolute values greater than 0.5 (not including the constant term).
```

Appendix (3-4): Correlation matrix of Banks–Corporate Stakeholder Orientation (the dependent variable is Liquidity position)[4]

```
Correlation matrix for coefficient estimates
-----------------------------------------------------------------------
                          CONSTANT            fx4
CONSTANT                    1.0000        -0.3155
fx4                        -0.3155         1.0000
-----------------------------------------------------------------------


The StatAdvisor
---------------
   This table shows estimated correlations between the coefficients in
the fitted model.  These correlations can be used to detect the
presence of serious multicollinearity, i.e., correlation amongst the
predictor variables.  In this case, there are no correlations with
absolute values greater than 0.5 (not including the constant term).
```

Appendix (3-5): Correlation matrix of Banks–Corporate Stakeholder Orientation (the dependent variable is Capital adequacy)[5]

```
Correlation matrix for coefficient estimates
-----------------------------------------------------------------------
                          CONSTANT            fx3
CONSTANT                    1.0000        -0.6226
fx3                        -0.6226         1.0000
-----------------------------------------------------------------------


The StatAdvisor
---------------
   This table shows estimated correlations between the coefficients in
the fitted model.  These correlations can be used to detect the
presence of serious multicollinearity, i.e., correlation amongst the
predictor variables.  In this case, there are no correlations with
absolute values greater than 0.5 (not including the constant term).
```

[3] fx2 = External relationship development.
[4] fx4 = The financial phase of corporate governance.
[5] fx3 = The orientation towards 'Stakeholders Management.'

Appendix (3-6): Correlation matrix of Banks–Corporate Stakeholder Orientation (the dependent variable is Asset quality)[6]

```
Correlation matrix for coefficient estimates
-----------------------------------------------------------------------
                         CONSTANT            fx3
CONSTANT                   1.0000        -0.6226
fx3                       -0.6226         1.0000
-----------------------------------------------------------------------


The StatAdvisor
---------------
   This table shows estimated correlations between the coefficients in
the fitted model.  These correlations can be used to detect the
presence of serious multicollinearity, i.e., correlation amongst the
predictor variables.  In this case, there are no correlations with
absolute values greater than 0.5 (not including the constant term).
```

Appendix (4-1): Correlation matrix of the banks performance measures.[7]

	Y11	Y12	Y13	Y21	Y22	Y23	Y31	Y32	Y33	Y41	Y42	Y43
Y11	1											
Y12	0.498	1										
Y13	0.861	0.796	1									
Y21	-0.25	-0.25	-0.17	1								
Y22	-0.17	-0.53	-0.03	0.736	1							
Y23	-0.13	-0.21	-0.09	0.962	0.74	1						
Y31	0.16	0.192	0.269	0.117	0.685	0.214	1					
Y32	0.212	0.265	0.335	0.1	-0.07	0.895	0.159	1				
Y33	0.108	0.106	0.118	0.028	0.015	0.649	0.158	0.693	1			
Y41	0.616	0.363	0.371	0.099	-0.12	0.236	0.235	0.628	0.792	1		
Y42	0.622	0.413	0.419	0.064	-0.18	0.218	0.323	0.717	0.192	0.164	1	
Y43	-0.05	0.423	-0.13	0.143	-0.49	0.089	0.048	0.08	-0.23	0.055	0.673	1

6 fx3 = The orientation towards 'Stakeholders Management.'

7 Y11= Operating Income/Total Assets, Y12= Net Interest Income/Total Revenue, Y13= ROA, Y21= Liquid Assets/Total Assets, Y22= Liquid Assets/Deposits, Y23= Liquid Assets/Deposits & Borrowing, Y31= Non-performing Loans/Total Loans, Y32= Reserves/Gross Loans, Y33= Provisions/Gross Loans, Y41= Shareholders Equity/Total Assets, Y42= Capital Funds/Total Assets, Y43= Deposits/Total Assets.

Appendix (4-2): Correlation matrix of banks' Drivers of Identity when they are emphasised (the dependent variable is ROA)

Correlation matrix for coefficient estimates

	CONSTANT	Agex2	CEOx2
CONSTANT	1.0000	-0.7501	-0.1900
Agex2	-0.7501	1.0000	-0.3552
CEOx2	-0.1900	-0.3552	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst th predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-3): Correlation matrix of banks' Drivers of Identity when they are emphasised (the dependent variable is NPL)

Correlation matrix for coefficient estimates

	CONSTANT	COOX2
CONSTANT	1.0000	-0.9010
COOX2	-0.9010	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst the predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-4): Correlation matrix of banks' Drivers of Identity when they are emphasised (the dependent variable is SHE)

Correlation matrix for coefficient estimates

	CONSTANT	Repux2
CONSTANT	1.0000	-0.9229
Repux2	-0.9229	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst th predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-5): Correlation matrix of banks' Drivers of Identity when they are emphasised (the dependent variable is DEP)

Correlation matrix for coefficient estimates

	CONSTANT	Sizex2
CONSTANT	1.0000	-0.9347
Sizex2	-0.9347	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients i the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst the predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-6): Correlation matrix of banks' Drivers of Identity for 'Highly ranked banks': when they are emphasised (the dependent variable is ROA)

Correlation matrix for coefficient estimates

	CONSTANT	coox2
CONSTANT	1.0000	-0.9169
coox2	-0.9169	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst th predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-7): Correlation matrix of banks' Drivers of Identity for 'Highly ranked banks': when they are emphasised (the dependent variable is SHE)

Correlation matrix for coefficient estimates

	CONSTANT	ceox2	coox2
CONSTANT	1.0000	-0.5561	-0.9014
ceox2	-0.5561	1.0000	0.3249
coox2	-0.9014	0.3249	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst th predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-8): Correlation matrix of banks' Drivers of Identity for 'Highly ranked banks': when they are emphasised (the dependent variable is DEP)

Correlation matrix for coefficient estimates

	CONSTANT	ceox2	coox2	prof
CONSTANT	1.0000	-0.2811	-0.3680	-0.44
ceox2	-0.2811	1.0000	0.4259	-0.26
coox2	-0.3680	0.4259	1.0000	-0.39
profx2	-0.4436	-0.2660	-0.3919	1.00
repux2	-0.4726	-0.2782	-0.4890	0.49

	repux2
CONSTANT	-0.4726
ceox2	-0.2782
coox2	-0.4890
profx2	0.4993
repux2	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients in the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst the predictor variables. In this case, there are no correlations with absolute value greater than 0.5 (not including the constant term).

Appendix (4-9): Correlation matrix of banks' Drivers of Identity for 'Lowly ranked banks': when they are emphasised (the dependent variable is ROA)

Correlation matrix for coefficient estimates

	CONSTANT	repux2
CONSTANT	1.0000	-0.8770
repux2	-0.8770	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients in the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst the predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-10): Correlation matrix of banks' Drivers of Identity for 'Lowly ranked banks': when they are emphasised (the dependent variable is NPL)

Correlation matrix for coefficient estimates

	CONSTANT	ceox2
CONSTANT	1.0000	-0.8831
ceox2	-0.8831	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients in the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst the predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-11): Correlation matrix of banks' Drivers of Identity for 'Lowly ranked banks': when they are emphasised (the dependent variable is SHE)

Correlation matrix for coefficient estimates

	CONSTANT	repux2	ceox2
CONSTANT	1.0000	-0.5530	-0.5817
repux2	-0.5530	1.0000	-0.2397
ceox2	-0.5817	-0.2397	1.0000

The StatAdvisor

This table shows estimated correlations between the coefficients in the fitted model. These correlations can be used to detect the presence of serious multicollinearity, i.e., correlation amongst the predictor variables. In this case, there are no correlations with absolute values greater than 0.5 (not including the constant term).

Appendix (4-12): Correlation matrix of banks' Drivers of Identity for 'Lowly ranked banks': when they are emphasised (the dependent variable is DEP)

```
Correlation matrix for coefficient estimates
-----------------------------------------------------------------------
                        CONSTANT           agex2          profx2
CONSTANT                  1.0000         -0.1589         -0.6046
agex2                    -0.1589          1.0000         -0.4356
profx2                   -0.6046         -0.4356          1.0000
-----------------------------------------------------------------------


The StatAdvisor
---------------
   This table shows estimated correlations between the coefficients in
the fitted model.  These correlations can be used to detect the
presence of serious multicollinearity, i.e., correlation amongst the
predictor variables.  In this case, there are no correlations with
absolute value greater than 0.5 (not including the constant term).
```

Appendix (5-1): List of the variables used to build the **Z**-score model

Ratio	Symbol
Return on Capital Employed	ROCE
Profit Margin	PM
Assets Turn	AT
Growth in Market Share	GMS
Value Added/Average Total Assets	VA/ATA
Sustainable Growth Rate	SGR
Internal Financing/Total Financing	IF/TF
Debt-to-Equity Ratio	DER
Foreign Component in a Company's Portfolio	FCCP
Return on Investment	ROI
Return on Sales	ROS
Cash Flow/Investment	CF/I
Sales/Total Employees	S/TM
Sales/Total Capital	S/TC
R&D/Sales	R&D/S
Working Capital/Sales	WC/S
Dividend Payout Ratio	DPR
Governmental Financing/Total Financing	GF/TF
Banking Financing/Total Financing	BF/TF
Foreign Debt/Total Financing	FD/TF
Inventory Weeks of Consumption	IWC
Capacity Utilisation (or Unemployed Capacity)	CU
Growth in Total Investments in Production Facilities	GTIPF
Growth in Investment in R&D	GIR&D
Variations in the availability of Qualified Employees	VQE
Rate of Defected Products	RDP

Cost of Capital	COC
Foreign Component	FC
Imports/Exports	Imp/Exp
Total Exports Growth	TEG
Exports/Industry Exports	Exp/I Exp
Exports/Sales	Exp/S
Standardised measure of risk	Std

Appendix (5-2): Correlation matrix of the variables used to build the **Z**-score model

	ROCE	PM	AT	GMS	VA/AT	IF/TF	DER	FCCP	ROS	CF/I	S/TM	S/TC	R&D/S	WC/S	DPR	GF/TF	BF/TF	FD/TF	IWC	CO	GTIPF	VQE	SGR	RDP	COC	FC	Imp/Ex	TEG	ExpIExp	Exp/S	Std
ROC	1.00																														
PM	0.98	1.00																													
AT	0.65	0.55	1.00																												
GMS	0.12	0.14	0.14	1.00																											
VA/AT	0.70	0.63	0.80	0.06	1.00																										
IF/TF	0.69	0.68	0.73	0.25	0.70	1.00																									
DER	-0.63	-0.62	-0.52	0.15	-0.56	-0.63	1.00																								
FCCP	-0.19	-0.19	-0.25	-0.08	-0.28	-0.32	0.07	1.00																							
ROS	0.98	1.00	0.55	0.14	0.62	0.66	-0.62	-0.20	1.00																						
CF/I	0.07	0.06	0.10	-0.13	0.06	-0.02	0.09	0.12	0.06	1.00																					
S/TM	0.47	0.50	0.47	0.52	0.20	0.59	-0.38	-0.20	0.50	0.03	1.00																				
S/TC	0.59	0.50	0.97	0.20	0.79	0.69	-0.49	-0.22	0.49	0.06	0.48	1.00																			
R&D/S	-0.03	-0.04	-0.15	-0.07	-0.03	0.07	0.07	-0.07	-0.03	-0.19	-0.25	-0.17	1.00																		
WC/S	-0.20	-0.18	-0.39	-0.04	-0.21	-0.18	0.31	-0.12	-0.16	-0.17	-0.30	-0.52	0.35	1.00																	
DPR	1.00	0.98	0.65	0.11	0.71	0.69	-0.63	-0.19	0.98	0.07	0.47	0.60	-0.02	-0.21	1.00																
GF/TF	-0.26	-0.30	-0.02	-0.16	-0.22	0.02	-0.14	0.23	-0.30	-0.14	-0.17	0.01	0.09	-0.22	-0.26	1.00															
BF/TF	-0.60	-0.61	-0.65	-0.34	-0.49	-0.73	0.72	0.05	-0.61	-0.01	-0.75	-0.68	0.20	0.54	-0.61	-0.14	1.00														
FD/TF	0.02	0.10	-0.07	0.36	-0.05	0.05	-0.04	0.28	0.10	0.24	0.21	-0.06	0.06	-0.15	0.02	-0.17	-0.20	1.00													
IWC	-0.37	-0.35	-0.54	-0.29	-0.24	-0.24	0.28	-0.07	-0.34	-0.28	-0.54	-0.54	0.23	0.51	-0.37	0.03	0.59	-0.26	1.00												
CO	0.02	0.07	-0.34	0.05	-0.14	-0.18	0.19	0.24	0.07	0.26	-0.13	-0.30	0.02	0.00	0.02	-0.22	0.15	0.06	0.09	1.00											
GTIPF	0.02	0.03	0.28	0.23	0.10	0.25	-0.07	-0.16	0.03	0.04	0.46	0.26	-0.24	0.01	0.02	-0.25	-0.17	0.30	-0.18	-0.22	1.00										
VQE	0.22	0.31	0.05	0.41	0.25	0.30	-0.31	-0.05	0.30	0.00	0.37	0.07	-0.32	-0.05	0.22	-0.20	-0.39	0.28	-0.28	0.21	0.19	1.00									
SGR	0.30	0.30	0.13	-0.11	0.20	0.14	-0.43	-0.08	0.30	-0.12	-0.06	0.07	0.31	0.03	0.30	-0.08	-0.08	0.10	0.03	0.06	-0.05	-0.08	1.00								
RDP	-0.05	-0.03	-0.29	-0.03	-0.19	-0.17	0.08	0.00	-0.02	0.00	-0.20	-0.32	0.05	0.14	-0.05	0.04	0.13	0.06	0.14	0.32	0.09	-0.02	0.09	1.00							
COC	-0.01	-0.03	0.33	0.26	0.06	0.25	-0.17	0.25	-0.04	-0.06	0.36	0.36	-0.43	-0.22	-0.01	0.10	-0.31	0.13	-0.12	-0.17	0.65	0.13	-0.12	-0.01	1.00						
FC	-0.13	-0.18	-0.02	-0.29	-0.06	0.01	0.09	-0.20	-0.17	-0.19	-0.24	0.00	-0.01	-0.07	-0.13	0.47	0.05	-0.32	0.18	-0.27	-0.30	-0.36	-0.37	-0.03	-0.25	1.00					
Imp/Exp	-0.12	-0.13	0.07	-0.09	-0.14	-0.19	0.00	-0.22	-0.13	-0.13	0.02	0.14	0.09	-0.13	-0.12	0.06	-0.04	-0.29	-0.07	-0.21	0.04	-0.27	0.13	-0.10	0.03	0.06	1.00				
TEG	-0.12	-0.13	0.16	0.01	0.01	-0.13	0.02	-0.20	-0.14	-0.07	0.16	0.23	-0.08	-0.11	-0.12	-0.02	-0.11	-0.19	-0.08	-0.30	0.29	-0.10	-0.09	-0.12	0.25	-0.06	0.74	1.00			
Exp/IEx	-0.23	-0.24	-0.11	-0.21	-0.16	-0.34	0.26	0.13	-0.24	0.84	-0.19	-0.09	-0.04	-0.08	-0.23	-0.04	0.20	0.05	-0.12	0.23	-0.06	-0.17	-0.11	0.01	-0.12	-0.19	0.27	0.31	1.00		
Exp/S	0.04	-0.04	0.24	-0.14	0.29	0.10	0.00	-0.06	-0.04	0.04	-0.29	0.20	0.06	0.04	0.05	0.33	0.12	-0.06	0.22	-0.28	-0.15	-0.31	0.13	-0.22	-0.07	0.35	-0.27	-0.04	-0.01	1.00	
Std	-0.53	-0.53	-0.46	0.18	-0.62	-0.48	0.48	0.25	-0.52	0.05	-0.10	-0.41	0.06	0.13	-0.53	0.17	0.23	0.10	0.16	-0.10	0.00	-0.26	-0.23	0.15	0.05	0.16	0.38	0.39	0.33	-0.05	1.00

Appendix (5-3): Output of the classification table (Accuracy-Matrix) of the discriminant analysis *

Case Number	Mis Val	Sel	Actual Group	Highest Probability Group	P(D/G)	P(G/D)	2nd Highest Group	P(G/D)	Discrim Scores
1			2	2	.4100	.9633	1	.0367	-.1457
2			2	2	.9358	.9959	1	.0041	.5977
3			2	2	.7043	.9990	1	.0010	1.0577
4			2	2	.6973	.9898	1	.0102	.2893
5			2	2	.0526	1.0000	1	.0000	2.6165
6			1	1	.9303	.9718	2	.0282	-2.4129
7			2 **	1	.5193	.7930	2	.2070	-1.6811
8			2 **	1	.7989	.9251	2	.0749	-2.0707
9			1	1	.4909	.7702	2	.2298	-1.6365
10			2	2	.7854	.9986	1	.0014	.9506
11			2	2	.8011	.9985	1	.0015	.9301
12			2	2	.9971	.9968	1	.0032	.6747
13			2	2	.2900	.9999	1	.0001	1.7363
14			2	2	.1570	1.0000	1	.0000	2.0934
15			2	2	.5261	.9789	1	.0211	.0442
16			1	1	.3003	.5418	2	.4582	-1.2896
17			1	1	.7763	.9842	2	.0158	-2.6095
18			2	2	.5785	.9994	1	.0006	1.2339
19			2	2	.6738	.9888	1	.0112	.2574
20			2	2	.6055	.9851	1	.0149	.1617
21			1	1	.6842	.9890	2	.0110	-2.7322
22			1	1	.5142	.9947	2	.0053	-2.9777

23	2	2	.7799	.9986	1	.0014	.9577
24	1	1	.7687	.9847	2	.0153	-2.6195
25	2	2	.2499	.9999	1	.0001	1.8288
26	2	2	.7911	.9929	1	.0071	.4133
27	2	2	.3734	.9998	1	.0002	1.5684
28	2	2	.9238	.9976	1	.0024	.7739
29	2	2	.5277	.9995	1	.0005	1.3097
30	2	2	.2273	.8925	1	.1075	-.5292
31	2	2	.5954	.9994	1	.0006	1.2093

. This table shows the results of using the derived discriminant functions to classify observations. It lists the two highest scores amongst the classification functions for each of the thirty one observations used to fit the model, as well as for any new observations. For example, row 1 scored highest for Grouping = 2 and second highest for Grouping = 1. In fact, the true value of Grouping was 2. Amongst the thirty one observations used to fit the model, twenty nine or 93.55% were correctly classified.

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